BETTER FINANCIAL REPORTING

by

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Preface and Acknowledgements

Improving financial reports of business, government and not-for-profit organizations has been a challenge. Misreporting by error or intent has not diminished. This book explores what we might mean by better financial reporting, and how we might move in that direction. Briefly, creating and maintaining institutions that follow a stable and conservative process for gradually adjusting the prevailing practices to any long-term shifts may build a better financial reporting environment. In contrast issuance of new rules, often disregarding the lessons of practice, have created much confusion and malfunctions in financial reporting over the past half-a-century. Resources and attention devoted to written rules have been accompanied by wasting of professional responsibility and regard for practice and practicality. This book argues for a better balance between top-down written rules and emergent social norms as reflected in business and accounting practice through scaling back on activist institutions of accounting.

The ideas and arguments presented here have been developed over four decades of teaching and research in accounting. I have learned from, and am indebted to my teachers, students, colleagues, co-authors, friends in the practice of business and accounting and other writers. Many of these ideas and arguments have already appeared in print elsewhere, and I have mentioned them to the extent possible. I have relied extensively on my own previously published work indicated by reference in appropriate places. I am also grateful to Stefan Reichelstein, the series editor, and publisher Zac Rolnik for their encouragement, support and patience.
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Samuel Johnson published his dictionary not as the conqueror of the language but as the person who knew best how unconquerable it really is.

Verlyn Klinkenborg (2005)

The rules of accounting, even more than those of law, are the product of experience rather than logic.

George O. May (1943)

Common global standards, if read to mean identical, is an illusory and unobtainable goal. However, seeking to achieve similar objectives and to address in an effective way similar problems is a realistic goal.

Richard Breeden (1992), Former Chair, U.S. Securities and Exchange Commission
Chapter 1: Introduction

What are, or should be, the properties of a financial reporting regime that could be characterized as better? Like the president of an organization, financial reports serve many masters whose diverse expectations are in frequent conflict, and in some cases those who occupy such high positions may consider their own personal interest to be paramount. A good financial reporting regime is often the result of creatively bargained trade-offs among its many functions, characteristics and constituents.

Attributes, Goals, and Practice

There are three broad approaches to defining better financial reporting, based on attributes, goals, and practice. The first approach specifies some attributes of good reporting. Truth is a favorite prescription. Some other judgmental attributes often mentioned include (in alphabetical order) comparability, conservatism, consistency, cost, fairness, neutrality, predictive value, relevance, reliability, representational faithfulness, timeliness, understandability, verifiability, and uniformity. In the absence of quantification and trade-offs they do not provide operational guidance for designing a financial reporting regime. Still, such lists serve as a useful agenda for discussion and analysis. Instead of judgmental attributes, financial reports can also be characterized by their statistical or descriptive contents. Correlation among security prices, volume, and other market, accounting, industry, or macro-economic variables, time series properties of reported variables, power to predict financial stress and other future events of interest, are examples of attributes that fall into this category.
A second approach is to focus on goals, either social, or of some specified individuals or groups. Generating greater wealth and prosperity for society by enabling organizations to operate more efficiently is an example of a social goal. Reducing the cost of capital for reporting entities is another frequently mentioned social goal of financial reporting.¹

Narrowing the focus to the goals of some individuals and groups that participate in organizations simplifies the problem. But it also sets aside the legitimate interests of other participants. For example, one could define better financial reporting to best serve the efficiency of investment decisions of equity holders of a business firm. Indeed, a large literature in accounting sets out to do just that, possibly because the data on the performance of equity investment is ubiquitously available. Popularity of this approach need not distract one from considering legitimate interests of other individuals and groups such as creditors, employees, communities, and government in financial reports of organizations.

Looking to practice for guidance on defining and understanding the financial reporting regime is the third major approach. Large parts of accounting, law, medicine, and other professions arise from practice and experience. They are based on what Hayek (1991) called “the extended order”: “… a framework of institutions – economic, legal, and moral – into which we fit ourselves by obeying certain rules of conduct that we never made, and which we have never understood in the sense of which we understand how the things that we manufacture function.” Even for the manufactured things, it is not clear how many people really understand how all their parts function; a car being an example.

¹ However, it is unclear why reducing the cost of capital to the investing entities should be socially desirable, when it also means reducing the rate of return to the investors (which is just the flip side of cost of capital). Reducing the price of potatoes simply transfers wealth/income from farmer to consumers without necessarily increasing or decreasing social welfare. What is so special about the price of capital to make this argument inapplicable to that context?
The role of social norms that emerge through a myriad interactions among individuals, organizations, and the socio-economic environment in shaping the financial reporting regime has received only limited attention in accounting literature. In a mechanistic perspective, a financial reporting regime may be thought to have been constructed from its elements—perhaps written rules—like a wall is constructed from bricks and mortar. While this perspective dominates accounting discourse, it has proved to be difficult to construct a practical model of accounting from its identifiable elements—the “bricks.” Instead, practice has important emergent properties seen in the extended order, but not in the components. Under this approach, long encapsulated in the meaning of the familiar phrase “generally accepted accounting principles,” a financial reporting regime arises from its general acceptance in the community of business managers, accountants, investors and employees, etc.

These three approaches—attributes, goals, and practice—are not mutually exclusive. It is unlikely that any one of them is entirely satisfactory by itself; they complement one another. This book argues for such a syncretic attitude to financial reporting

Perspectives by Time Scale

Perspectives varied by detail and time often yield different insights into the nature and origins of a phenomenon. For example, walking through a neighborhood, flying over a city, and looking at earth from outer space allow one to see the same surface of the earth at very different scales and detail, and yield related but quite different understandings of the dwellings, landscape, and activities observed (see Figure 1). We can look at financial reporting also from various perspectives of time and detail. An auditor learns about
different aspects of the same firm in checking a sheaf of customer invoices, in conducting
an analytical review of the financial statements, or in assessing the performance of an
organization over the years. The facts rarely speak for themselves; what we observe
depends on the level of spatial or temporal detail in our chosen perspective, and what we
are looking for in a given perspective.²

(Insert Figure 1 about here)

Rules and Institutions

It is useful to think of three levels of analysis in accounting: transactions, rules for
classifying and reporting transactions, and socio-political-economic institutions for
making, implementing, and enforcing the rules. Since all events are not treated as
transactions in accounting, the first level of analysis identifies which events are treated as
transactions. The second level develops a classification scheme for transactions based on
their observable attributes, and deciding how each class of transaction is to be recorded
and reported. At the third level lies the development of institutions to perform and
oversee the tasks at the first two levels. Besides the legislatures and courts, bureaucratic
regulatory and coordination structures in the government and private sector are examples
of such institutions in the U.S.

Most accounting instruction concerns learning to identify events that are considered
transactions, and to decide how the transactions are to be classified and reported in a
given regime. How and why the rule-making institutions choose a particular rule receives
less attention in classes. Even rarer is the analysis of the alternative design or evolution of

² www.invisiblegorilla.com has interesting video examples of the phenomenon that people do not notice
“obvious” things when they are not looking for them (accessed July 31, 2015).
institutions. These oft-ignored topics are important because the structure of institutions helps determine the scope and nature of the rules they make.

For understanding accounting regimes, a broad perspective on accounting institutions that create the regimes is needed. In the United States, for example, the relevant accounting institutions include not only the obvious candidates such as the federal Securities and Exchange Commission, the Financial (as well as Government) Accounting Standards Board, Government Accountability Office, and the Public Company Accounting Oversight Board, but also the American Institute of Certified Public Accountants, state securities regulators and CPA societies, various state and federal courts and industry regulatory commissions and revenue departments, all operating under their respective legislation, charter, regulations and procedures. We shall confine our attention here to the first few named above.

Social Norms

While rules and institutions are more formal, a great deal of our lives, including professional practice, is governed by less well-defined social norms. These are shared expectations held of one another’s behavior in the relevant community. In a broader sense, social norms are also an institution. Although they have played an important role in accounting, other professions and various aspects of our lives, their role has been declining during the recent decades. We shall explore the possible reasons and consequences of this phenomenon and discuss options for the future.

Learning and Development
Social systems, like individuals, learn, develop, and change over time. To the extent we can design the institutions of accounting, they need to have a built-in capacity to learn and adapt to changes in the environment. Standardization of practice and their adaptation have an inherent conflict. Widely adopted and enforced standards are also more difficult to adapt to changes. For example, the United States was the first to invest large amounts of capital in mechanization of weights and measures, and that standardization has made it more costly and difficult to adopt the metric system now used almost everywhere else in the world.

In the past two decades, there has been a strong push towards standardization of financial reporting across the world. We analyze the unintended consequences of standardization with such a broad scope for the future of financial reporting.

Ways Forward

Finally, we explore the future of financial reporting, especially in light of the active interaction among financial reporting, law and financial engineering. The environment of financial reporting is defined in a significant measure by law and financial engineering. To the extent that rules of financial reporting are written down, they facilitate attempts of managers and their advisors to design newer transactions, instruments, and even organizational forms to defeat the intent of the rules.

Ultimately, the boundaries of a financial reporting regime are defined by law. Many conflicts and disagreements about accounting and auditing end up in the courts of law for final resolution. A greater role for the common law approach where community norms are decisive may help improve financial reporting.
References

Figure 1: Three Perspectives on the Surface of the Earth

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<th>Ground Level</th>
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There is little agreement on an answer to this question. Consider seven perspectives to identify “better” financial reporting; three based on attributes of financial reports, three on the goals they serve, and one being the current practice (Sunder 2015). The attribute-based approaches include (1) pursuit of truth, (2) assessment based on judgmental attributes of the reports considered desirable, harmful, or deserving a balance, and (3) some measurable statistical or descriptive properties of the data, disclosures, and explanations contained in the reports. Three objectives-based approaches include (1) seeking to fulfil some objectives of financial reporting itself (2) the efficacy of financial reporting in serving some broad societal goals, and (3) fulfilling the goals of one or more specific classes of participants. A final approach sees accounting simply as a social practice, arising from complex human interactions, but not necessarily derivable from known attributes or goals.

Given the nature of collective choice and social policy, it is rare for such attempts to clearly identify what better financial reporting is. Trade-offs must be made in the presence of non-commensurate and conflicting attributes, as well as within- and across-person objectives. The absence of reasonable data on preferences, costs and benefits lead to ambiguous conclusions. Indeed, caution is necessary because it is a challenge to be both knowledgeable and confident about such formulations.
Attributes of financial reporting

Pursuit of truth is often mentioned as a desired property of financial reporting focused on just facts. Despite its apparent simplicity, difficulties arise in practical application of the criterion. For example, MacNeal (1939) considers market values to be the only truth. In his review of MacNeal’s book, Paton (1940) pointed out the arbitrary nature of what is chosen as the truth. In accounting, as elsewhere in life, the appeal of pursuing the simple truth is difficult to resist. The problem is that what is simple is not always true; what is true may not be simple. Moreover, from a statistical perspective, truth is not a 0-1 property, but a matter of degree which might be measured by root mean squared deviation or other similar metrics of precision or its inverse.

When quantified in this manner, it is difficult to defend truth as the ultimate determinant of the quality of financial reporting; trade-offs with other attributes come to mind immediately. Use of “true and fair” as a criterion in financial reporting is an attempt to bring in this balance the starkness of “true” by itself with the global judgment and the sense of balance that “fair” brings to financial reporting (Sunder 2010b). True-and-fair is also an easy-to-comprehend benchmark for financial reporting that does not depend on technical jargon of accounting; the president of the United States used it in his promise to the public on July 9, 2002 in the aftermath of Enron, WorldCom, etc.: “We are moving corporate accounting out of the shadows so the investing public will have a true and fair and timely picture of assets and liabilities and income of publicly traded companies.” Not surprisingly, companies in the U.K. where true-and-fair override is permitted tend to use it opportunistically to spruce up their weak performance and results in less informative financial reports (Livne and McNichols 2009).
Other Qualitative Attributes

Over years of accounting discourse, faithful representation, timeliness, relevance, reliability, verifiability, uniformity, consistency, comparability, cost-benefit efficiency, conservatism, and robustness to manipulation and fraud are among the proposed attributes a preferred system of financial reporting should have. In the context of governmental organizations, transparency, public accountability, and citizen empowerment and engagement with the organization are often added as desirable attributes of their financial reporting.

Most of these attributes are widely discussed and largely accepted to be desirable in financial reports with four important caveats. When choosing between two or more alternative practices, such a list of desirable attributes inevitably forces the rule maker to make difficult trade-offs between various pairs of attributes, say, faithful representation and timeliness, and between relevance and reliability. The list of attributes itself provides little guidance on making such trade-offs to attain better financial reporting. Second, it is difficult to resolve conflicts among the interests of preparers, auditors, and users; what is desirable to one group is not necessarily so for the others. Third, the meaning of terms such as uniformity, comparability, and conservatism, which is obvious at a cursory glance, becomes less clear on closer scrutiny. Uniformity of classification has no obvious interpretation in a multi-attribute world, because “similar treatment of two transactions which have any similarity” and “dissimilar treatment of two transactions which have any dissimilarity” yields radically different destinations in pursuit of uniformity (Sunder 1984, 1997 Chapter 9). Comparability in a world where no two transactions or events are exactly alike is similarly undefinable. For example, Weinberg (1992, Chapter 2, “On a
piece of a chalk”) argues that it is not possible to completely define even a simple object such as a piece of chalk. If one is willing to go into enough details, no two pieces are alike. The same is true of accounting events and transactions.

Joyce et al. (1982) found from their experiment with the former members of the Accounting Principles Board and the Financial Accounting Standards Board that they agreed sufficiently on the meaning and importance of only two of the eleven attributes they examined—cost and verifiability; others proved to be too difficult to operationalize.

Disclosures

Users of financial reports are not shy to ask for additional disclosures in financial reports, and sometimes use greater and more timely disclosure as a measure of better financial reporting. It has been suggested that financial reports include consolidation of controlled entities, separate business and geographical segments, quarterly results, and disclosures of financial instruments, off-balance sheet financing, uncertainties, and separate core from non-core businesses. In 1994 AICPA’s Jenkins Committee recommended that reports include not only financial but also non-financial information. After the practice and the legal regime had long discouraged inclusion of forward looking information for the fear of fraud and lies, Jenkins Committee and the US Congress also encouraged inclusion of such information in corporate financial reports under a safe harbor rule (i.e., no penalties if such information subsequently turns out to be wrong).

Such demands for additional disclosures land on the doorsteps of regulators, and are generally resisted by preparers, typically on grounds of either direct costs of disclosure, or indirect costs of giving away proprietary information to competitors. Preparers would
rather decide for themselves which information to disclose and when to do so. Choosing to disclose information is a signaling instrument for preparers, and regulated disclosure deprives the better organizations of this useful instrument for distinguishing themselves from organizations with weaker performance (Dye 1985 and Levine 1996).

When regulators yield to requests for mandating additional disclosures in financial reports, the reports may become more detailed, but not necessarily more informative. Important pieces of information can get lost in voluminous details included in the report to fulfil regulatory requirements. Bloomfield (2012) argues that the firms be encouraged or required to draw readers’ attention to important items by “elevating” them above the less important details. Heterogeneity of interests of the user community with respect to the relative importance of disclosures makes implementation of this proposal a difficult challenge.

Data with specific statistical properties

Beyond the qualitative characteristics and disclosures discussed above, the meaning of better financial reporting can also be specified in terms of statistical attributes of the reported data. Perhaps the best known of such attributes is the correlation between accounting and stock market data. Larger correlation is treated as a measure of better financial reporting under the catchy but often misleading label of “value relevant” reporting. Value relevance implies causation from financial reports to market values, but causal inference from correlations is difficult to make. Security markets process information from multiple sources to arrive at prices; any correlations between accounting and market data cannot be assumed to be rooted in financial reports alone.
Third, this value relevance perspective on better financial reporting assumes that security markets are efficient (in the sense of the prices being in the neighborhood of the fundamental values), in spite of large empirical and theoretical evidence to the contrary (Shiller 2000). Finally, this perspective reverses the dependence of market prices (and other data) on information (including financial reports), to make market prices the ultimate arbiter of what information financial reports should furnish to the market. In other words, instead of being “for the markets”, financial reporting becomes derived “from the markets” (Sunder 2011).

To the extent financial reports may help make better decisions such as valuation, lending, and various kinds of predictions including financial distress and bankruptcy, regulation of banks and utilities, and attracting investment and human capital to productive enterprises, it is possible to define better financial reporting on the basis of the quality of decisions financial reporting may be able to support. Since decision models as a function of financial data can always be adjusted, which financial reporting regimes yield better basis for making various kinds of decisions is largely an empirical matter. The empirical results depend not only on the financial reporting regimes but also on how well the decision models have been adapted to each of the regimes being compared. Since most jurisdictions allow only one financial reporting regime to operate for a given class of firms, such empirical comparisons of decision-usefulness must necessarily depend either on cross-sectional comparisons across jurisdictions or time-series comparisons with a jurisdiction when a regime is changed. Controlling for everything else being not equal in such studies renders empirical determinations of better financial reporting a difficult challenge.
Goals and objectives

In the preceding section we have discussed attempts to define better financial reporting in terms of their desired attributes including truth, other qualitative characteristics, disclosure, and statistical properties. Another way of approaching better financial reporting is by considering goals or objectives of financial reporting itself, of society, and of some specific members or groups in society. Since financial reports are artifacts created to serve human objectives, it seems best to resolve the objectives of financial reports into human objectives at either societal or group or individual levels as proposed by Dopuch and Sunder (1980).4

Societal goals

That financial reporting should serve broadly-defined societal goals such as the creation of wealth and livelihood, promotion of social cohesion and justice, and creation of markets for physical, financial and human capital that promote economic efficiency is widely supported. However, like other broad propositions, agreement on which financial reporting regimes are better at attaining such goals is less likely.

The higher material wellbeing of society today is a result of organizing individual talent and effort in small or large groups and communities, and linking them so they can interact in transient but predictable ways. The existence and functioning of these organizations in public and private sectors is made possible by financial reporting. Organizations gather physical, human and financial capital and organize it to produce social surplus, which is their economic contribution to society.

4 They also analyze three important but largely overlapping official pronouncements (Accounting Principles Board Statement 4 or APBS4, Trueblood Report or AICPA 1973, and Statement of Financial Accounting Concepts 1 or FASB 1978) to define these objectives.
Accounting and financial reports are necessary for organizations to attract various forms of capital, and to ensure that they have a reasonable chance of receiving their share of returns on their respective contributions (Sunder 1997). In this sense, financial reporting is necessary for organizations, including society, which is a larger organization, to sustain itself.

The theme of a recent conference organized by the Institute of Chartered Accountants of England & Wales was “Information for Better Markets.” It would be a stretch to imply that markets should be treated as stand-ins for the economy or society as a whole (and the organizers didn’t do so). The idea of “better markets” needs some further explication because the term could be used to refer to market volume, information efficiency, allocative efficiency, liquidity, low transactions cost, broad accessibility, transparency, etc. Also, market organizations are not necessarily neutral, and they can favor some participants at the expense of others. They can be organized to favor dealers, brokers, institutions, small investors, or investors in companies who run the stock exchanges. Considering all these possibilities, it is unclear how one might choose an accounting regime to create better markets.

In a world where individuals seek their own respective goals, financial reports help organize them into coordinated networks, inform them about the functioning of the network, as well as discipline individuals so their personal pursuits do not overwhelm its collective functions. Financial reporting disciplines not only the individual actions but also alternative and competing sources of information they may have access to. In this sense, financial reporting helps build stability and an element of predictability to the functioning of organizations.
It has often been claimed that an important function of financial reporting in business organizations is to help reduce their cost of capital. This argument is subject to two objections. First, cost to a business organization is profit to the investor supplying the capital. To claim that financial reporting should be chosen to reduce the cost of capital also says that it should be chosen to reduce the returns to investors. Second, cost of capital is just another price (i.e., a rate of exchange) of a factor of production, and it has not been shown that lowering the price of capital (or of cars, food, or anything else), improves social welfare.

Goals of individuals

Addressing the interests of various classes of participants in an organization is a third approach to giving meaning to better financial reporting. Enabling them to make better-informed private decisions of their own is mentioned often. In this decision-making perspective, it is assumed that the participants have their preferences and objectives, which they combine with information from financial reports and alternative sources to formulate and solve their decision problem. More broadly, this meaning of better financial reporting can be said to help the participants of an organization improve their individual and collective welfare.

Four sources of ambiguity arise in this meaning. The goals and information demands of various groups of participants do not coincide across, and even within, the groups. It is difficult to choose a financial reporting system to serve a diverse assembly that may include diametrically opposed interests. A second problem is that information needed by individuals may depend on their personal circumstances, which change dynamically, and
are unknown and unknowable to those who select the financial reporting system. Third, individual decision usefulness criterion for better financial reporting assumes little or no interaction among their decisions. But interactions among rational decisions of “better informed” individuals may yield less desirable outcomes for some or all of them, as compared to outcomes from not-so-informed decisions. Fourth, as Demski (1973) points out, from Blackwell’s (1979) theorem, we know that a better information system for individual decision must be strictly finer, and this fineness condition is not likely to be met by any standard, with the possible exception of Sorter’s (1969) “events” approach to accounting, a topic to which we return in a later section.

These difficulties with defining better financial reporting in terms of information for decision making have often been sought to be ameliorated by narrowing the presumed target of financial reporting to a single group—investors, sometimes narrowed even further to shareholders. Although the vast literature that adopts this “shareholder perspective” on merits of financial reporting rarely articulates its rationale, we can venture some guesses. First, a plausible reason lies in the large following of Milton Friedman’s widely misunderstood dictum “profit is the only goal of business”, transformed into “maximizing shareholder values (as measured by the market price of shares) is the only goal of business.” From there comes the long, incredible, but apparently innocuous leap: “maximizing share prices is the goal of financial reporting regulators/standard-setters.” This leap has two important dimensions. Shareholders are not the only group in society whose interests regulators and standards are charged with
Financial Reporting as an Emergent Practice

Beyond following some desired attributes or goals, one can look at financial reporting simply as a social phenomenon that just “happens,” like the ways in which we eat, wear clothes, speak, relate to one another, work, and entertain ourselves. Since complexity of social phenomena makes it difficult to derive our way of living as rational constructions from some well-defined preferences, attributes and goals, we tend to rationalize it anyway. In fact, more often than not, we infer the preferences and goals from the way we live (e.g., he must like blue color because he is wearing a blue shirt).

In accounting, this Panglossian perspective, after the optimistic tutor Pangloss in Voltaire’s Candide (1759) has a large following. Accounting is the way it is, the argument goes, because it must be the best; otherwise it would not have been this way. Popularity of this so-called “positive theory” has almost excluded serious discussions of policy problems of accounting (which is addressed in the title and content of this book) from important parts of accounting literature during recent decades.

As a practice, financial reporting can also be seen as a ritual of modern life. Rituals are repeated sequences of actions performed in religious, social, organizational, and individual contexts, either without a stated purpose, or without an empirically identifiable link to their purported purpose. They are explanations of themselves—we do them.

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5 In the wake of financial reporting scandal at Enron in 2001, the stock price dropped from 90s to less than a dollar. According to one estimate, Enron should have been worth about $5 at the time. Whether the shareholders lost $85 (= 90-5) or $4 (= 5-1) is a matter of some debate. Are shareholders interested in financial reports that accurately reflect or maximize the value of their stakes should not be, but remains, controversial.
because we do them. University commencements, tribal rain dances, visits to places of worship, wedding and funeral ceremonies, greetings and goodbyes are examples of rituals that pervade life in all societies. According to Bell (1997) rituals may be prescribed by the traditions of a community and characterized by formalism, traditionalism, invariance, rule-governance, sacral symbolism, and performance. To a skeptical eye, financial reporting also appears as a ritual full of symbolism, and little substance.

Some purposive activities continue through the force of habit, tradition, or superstition long after their original purpose is lost to changing circumstances or social memory. Better “rain dance” is not assessed by whether precipitation follows; other measures such as the number of participants, colors of the costumes, or sumptuousness of the feast that follows may replace the objective criteria. Until better evidence on instrumental effectiveness of financial reporting in attaining its attribute- or goal-based rationalizations becomes available, financial reporting-as-a-ritual cannot be rejected out of hand.

Summary

In summary, “better” in financial reporting could be defined to mean many things: meeting specified societal or individual goals, or possessing some general qualitative or specific statistical attributes. It is difficult, even at a conceptual level, to obtain agreement of what kind of financial reports do or can meet the criteria within any one of these interpretations, much less all of them. We do not even know if it is simply a ritual we engage in because we do. After exploring the range of possibilities, we return to this question in the final chapter.
References


How do we think about, design and choose better financial reporting regimes? The topic has received much attention during the past century. An initial step towards progress is to recognize that this problem is not unique to accounting. Humanity has strived to find better ways of organizing various aspects of society over the millennia. Since standard-setting has been an important part of defining financial reporting regime over the past century, it is worth noting that there are more than five hundred domestic standard-setting organizations in the United States alone, and many more in other countries, engaged in the task of defining the technical and business environment and setting standards for everything from ships to sockets. In addition, there are international bodies that do the same for diverse fields such as communications across national boundaries. Reflecting on the problem of setting accounting regime in the larger context of parallel social processes for other products and services may help us appreciate the costs, benefits, limitations, and economics of developing a better financial reporting regime (Jamal and Sunder 2014).

Divergence in social policy is hardly unique to financial reporting; it is common to most aspects of law, regulation, and collective choice in general. Financial reporting includes elements of collective as well as private choice. Looking at aspects of economic life outside accounting may help us. Analytical derivation of solutions to problems of collective choice is difficult for reasons similar to those outlined for the problem of selecting criteria for better accounting in Chapter 2. Process can be an alternative to criteria for choice. Perhaps it is possible to develop a socially acceptable process for defining and developing financial reporting in the hope that its outcome will be an
improvement, at least by some broad subjective judgments if not by criteria-based
analysis.

Mechanisms and Processes for Collective Choice in Accounting

Given the difficulties of choosing and applying a priori social welfare criteria, human
societies have developed and employed a variety of social choice mechanisms to solve
the problem. While rules written by a regulatory body are frequently employed in
financial reporting, they are neither the only nor necessarily the best mechanism for all
aspects of financial reporting. At the outset, it is useful to consider the characteristics of
the available alternatives. They can be classified into eight broad categories—social
norms, popular vote or referendum, legislation or statutes, courts, bureaucratic regulation,
self-regulation, and market—recognizing that in practice they may coexist (Sunder 1988).

Social norms

Social norms, such as natural languages, emerge from grass roots. It is the most diffused
of collective choice mechanisms with a minimum role for a centralized authority. The
process of such emergence is not well-understood, and it does not produce results on the
demands of a time table. It can deal with matters of broad principle, as well as fine-
grained distinctions. Paciolo's fifteenth century text codified the prevailing accounting
practices of Italian merchants of his time. In this sense, the book can be seen as an
attempt to capture the social norm of accounting at that time. Indeed, the phrase
“generally accepted accounting principles” reflects the grass roots social norm origins of
accounting and financial reporting.
Financial reporting was largely left to be defined by the social norms until the number and size of publicly owned business enterprises grew to account for a significant proportion of economic activity. Rapid growth of larger complex publicly-traded organizations in manufacturing, transportation, utility, and service industries placed additional demands on financial reporting systems that could not easily be met by the social norms approach; in the twentieth century, the GAAP label was appropriated by corporate bodies created with legal authority to make and impose top-down rules on reporting entities. Social norms have taken a back seat ever since.

Popular Vote or Referendum

In making collective choice by popular vote or a referendum, individual citizen have the chance to indicate their preference directly. Referenda can work reasonably well as social decision mechanisms when the citizens have to choose from only a few simple, ready-to-understand alternatives such as “X or Y” or “Yes or No”. Permitting legalized gambling, the sale of alcoholic beverages, and caps on real estate taxes are examples of issues amenable to this form of collective decision-making. As the number and complexity of alternatives increases, the efficacy of a popular vote is diminished because most citizens cannot have the knowledge to make an informed choice, and formulation of alternatives presented to the citizens itself becomes an important part of decision that cannot be handled by referenda. Moreover, when the voters do not comprehend the implications of the collective choice at stake, they become more susceptible to suggestions, advertising, and demagoguery. It is not surprising that financial reporting choices have not been made by this method.
Statutes and Legislation

Statutes are top-down decisions of the ruling dispensation. In democratic systems formulation, debate, and approval of statutes is entrusted to a legislature consisting of representatives elected by constituents to speak on their behalf. Whether the legislature passes a statute depends on the level of support for such action from a sufficient number, usually a majority, of its members. It can take no action unless one of the proposals on the table gains enough support. But “no legislation” is also a choice for leaving the status quo undisturbed.

Legislators are free to argue for proposals that favor them or their constituents, and are not shy to do so. In legislative decision making the conflicting interests are articulated, debated, and bargained on, with little of their reasoning and motivations left hidden (except when bargaining occurs in the proverbial “smoke filled” rooms off the legislative floor). All sides get the chance to air their views. Given their broad responsibilities across the range of issues in political domain, few legislators can be expected to have the time, ability, or inclination to become knowledgeable about technically complex issues such as financial reporting. Even when legislators engage with such issues, they may not understand them, and leave the details to be worked on by their staff. In the 1990s, the US Congress got involved in accounting for executive stock options under lobbying pressures from the technology industry, and it took many years for US financial reporting to recover from that intervention. The French government’s intervention with the International Accounting Standards Board in the wake of accounting problems at Societe Generale had similar effects. The title of Romano’s
(2005) paper “Sarbanes-Oxley Act and the Making of Quack Corporate Governance” articulates the serious doubts about the wisdom of direct legislative intervention in financial reporting.

Courts

Unlike the legislatures where the members are free to argue for their own or constituent interests, judges in courts must maintain neutrality. While judges also are under pressure of the arguments advanced by the plaintiffs and defendants, they are expected to decide on the basis of common or statutory law, and not on their personal preferences. Violations of this judicial norm risk loss of status for the judge. In contrast with the legislators who may consider multiple alternatives, courts typically have only two sides before them, and must decide one way or the other.

Spacek (1958) headed the major accounting firm of Arthur Andersen & Co. when he proposed that financial reporting disputes be resolved in a specialized accounting court endowed with expertise to handle the finer points and technical details that might be lost in a general court. Such a court might be able to use common law to make judgments about whether the financial reports under scrutiny present a “true and fair” picture of the status and the performance of the relevant entity in a manner analogous to determination of “guilty beyond a reasonable doubt” in criminal cases. Creation of such courts may help reduce the rapidly expanding administrative and regulatory burdens of making and enforcing rules. Spacek’s proposal has not received much traction in the accounting, business or regulatory communities over half-a-century. Instead, the administrative and
regulatory approaches to address the problems of financial reporting have become more entrenched.

Administrative and Regulatory Agency

In the 1930s, the US Congress handed the responsibility for regulation of publicly traded companies’ financial reporting to the newly created Securities and Exchange Commission. Commissioners of the SEC, as well as other regulatory agencies in the U.S. system, function largely independently of the executive branch of government, and are answerable to the US Congress. This administrative arrangement has yielded effective regulation (e.g., of insider trading), innovation and experimentation with regulatory methods (e.g., accounting for inflation and for oil and gas exploration), as well as major failures to maintain the quality of financial reports (e.g., Enron, WorldCom, GlobalCrossing, etc.).

Administrative approach to regulation appears to work well when the agencies exercise their discretionary powers and judgment in public interest. For example, the refusal of the SEC to define insider trading beyond “trading on non-public information” has enabled it a measure of success in prosecuting many cases. The agency has been under constant pressure to clarify “trading on non-public information.” Had it yielded to that pressure, as did regulators in Japan, the SEC would have found it more difficult to prosecute wrongdoers who use such definitions as a road map for evasion.

This points to the basic dilemma of regulators. If they write down only general principles, they allow themselves room to exercise their judgment in bringing enforcement actions when they see a violation of the principles. The defense usually
consists of pointing out the lack of specificity in the principles, and calls for clarification (or "guidance", a frequently used term in the context of financial reporting). Every clarification adds details to the principles—a step in transforming them into rules, and opening up new loopholes. Detail and complexity gradually inches up on demand from the regulatees, making it progressively difficult for the agency to exercise judgment based on general principles of reporting. The failure to follow this process attracts charges of arbitrariness and absence of due process, which are difficult to rebut in a democratic polity.

Self-Regulation

Self-regulation allows a profession or industry to create and operate its own system of regulating the behavior of its members and the quality of their goods or services. Such organizations exist across many parts of the economy to set standards, monitor quality and performance, and take punitive actions when necessary. Self-regulatory organizations tend to be more effective in creating coordination standards which become largely self-enforcing. If the Association of American Railroads were to set a standard for rails to be placed one meter apart, it is in the interest of virtually all railroads to conform to the standard, even if they have not participated in setting that standard.

The same is not true of quality standards, because individuals have incentives to cut corners by free-riding on industry reputation, especially if the quality is not easily observable to their customers. For this reason, self-regulatory organizations tend to be concentrated in coordination work, and government standards play a stronger role where quality is concerned (see Jamal and Sunder 2014).
Over its eighty-year history, the US SEC has encouraged the creation of self-regulatory organizations in financial reporting and relied on them to a significant degree. In its early years, the SEC let the American Institute of Certified Public Accountants—a professional association—set the financial reporting standards through its committees such as the Committee on Accounting Procedure (CAP) and the Accounting Principles Board (APB). In 1972, the APB was replaced by another self-regulatory structure (including Financial Accounting Foundation (FAF), Financial Accounting Standards Board (FASB) and Government Accounting Standards Board (GASB)) with broader representation from outside the accounting profession which nevertheless retained the majority of seats in the FASB. These organizations worked closely with the SEC’s Chief Accountant’s Office, and rarely issued rules without prior consent of the latter. Under this arrangement, following the preparers’ continual demands for clarification and guidance, the body of written rules that are now supposed to constitute the “Generally Accepted Accounting Principles” has grown to some tens of thousands of pages.

Markets

In the absence of externalities and with sufficient competition, markets offer an efficient solution for the problem of producing and allocating private goods. Information contained in published financial reporting has both the zero marginal cost and the non-excludability properties of public goods. The cost of producing these reports includes two parts. The first is the out-of-pocket cost of preparing the reports from the transactions database (which the organization must maintain in any case for managing its operations

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6 Private goods are defined in contradistinction to public goods (zero marginal cost of producing additional units and non-excludability of the non-payers from the benefits. The limited concept of efficiency used here does not include consideration of distribution and fairness.
and exercising internal control). Perhaps a larger cost takes the more difficult to quantify form of regulatory compliance, and the changes in behavior of management induced by financial reporting regulations. Consideration of these public goods aspects of financial reporting information points to addressing it as a collective and not as a private choice problem.

As discussed earlier, entrusting the problem to one of the collective choice mechanisms—legislatures, courts, referendums, regulators and markets--does not resolve the difficulties of identifying better reporting methods. However, one can conceive of a system of competition among alternative sets of rules by which markets operate (e.g., stock exchanges, environmental regulations, educational systems, etc.) These alternative sets can be made into private goods by demanding a fee or tax from those who choose to participate in them.

Summary

Selecting a financial reporting regime is more than a technical matter. Technical expertise is important but not sufficient. We need to consider both social efficiency (a technical matter) and distribution of wealth (a political matter). In political matters, people can differ without any one being wrong. The quasi-judicial structure of the FASB, combined with its technical staff, has given a technical flavor to its task and for many years the FASB remained reluctant to recognize the political (i.e., distributional) aspects of its work. IASB, consisting of representatives chosen from specific countries is less cagey about acknowledging country-specific interests. A legislative system shifts the emphasis towards the political considerations, although the members of any structure for
selecting a financial reporting regime must still maintain a high level of technical competence.

Participation of neutral parties who presumably have no identifiable political interests as a class in the setting of accounting standards to standard-setting bodies tends to detract from the political aspects of its task. They need not be voting members in such quasi-legislative structures and provide valuable advisory and technical support as members of the staff.

No standard is indispensable. People can and do live without comprehensive written standards in all domains of our life. Absence of a standard is rarely catastrophic; people adjust their behavior to the status quo. On the contrary, issuance of a standard can inflict much damage. The performance of a standards organization cannot be measured by the number of pages of standards issued any more than the success of a legislature can be judged by the number of laws passed. There is not even an approximate connection between the two. Is an active parliament a good parliament? Is an active standard setter a good standard setter? We must get rid of the habit of carrying the positive image of “proactive” behavior from the personal to this institutional domain (Sunder 1981).

Refusal of a standard-setting body to issue aggressive standards means delay in standardizing the treatment of newer types of business transactions and events. It is no more reasonable to expect that accountants can instantaneously come up with efficient standards for newer types of business transactions than that physicians can find immediately a cure for newly discovered diseases or that engineers can fix a design weakness overnight. The imperfection of our knowledge generates the necessity to conduct field testing of a variety of solutions to new problems. Forcibly speeding up the
process imposes the large costs of making mistakes, changes, and resultant confusion in
financial markets. Accountants who worry that the Securities and Exchange Commission
may not accept a slower pace of response to new issues should remember the
consequences of the SEC’s not-so-well-thought-out and ultimately unsuccessful
intervention with the oil and gas reserve recognition accounting in the 1970s.

No matter what institutional mechanism we devise to set an accounting regime, our
ability to identify socially superior solutions will remain limited and imperfect. We
cannot observe other people's preferences; people's preferences depend on what they
know and their past experience, which change continually. When new solutions or rules
are implemented, people adjust their behavior to the new situations. Therefore, an
understanding and observing of how people change their behavior in response to new
standards is indispensable to devising a socially efficient reporting regime. The more
aggressive a rule is, the less likely it is that we have a reasonable ex ante understanding of
its consequences. Perhaps the practice-based orientation of accounting regimes deserve
more attention.

As we move from common law towards bureaucratic mechanisms, fewer people are
directly involved in making decisions, more of the power of an organized state is brought
to enforce the decisions, decisions can be made and enforced more expeditiously, and the
chances of making errors increase. Historically, this has been the direction of change in
the United States and the European Union in the recent decades. Given the prevailing
level of dissatisfaction with the financial reporting regime, we should consider where we
might have gone wrong in conceptualizing the meaning of better financial reporting, and
means of achieving that end. The following three chapters explore three major
approaches—rules, norms and institutions before returning to the problem of developing better financial reporting in Chapter 7.

References

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4: Standards and Rules

After a brief review of the economics of standardization, I discuss the problem of identifying optimal standards, comparison of accounting standard setting with the standard setting process in four technologically oriented organizations. A brief history of accounting rule making in US completes this chapter.

Economics of standardization

It is costly to keep inventories, to gather and process information, and to negotiate contracts. The desire to cut these costs motivates us to standardize. This is true of electrical adapters to fit wall outlets, the 110-volt household power supply, and thousands of articles of daily use and means of communication such as language, phone and internet. Without standardization to facilitate coordination, modern life would be cumbersome if not impossible.

Coordination standards are concerned with the mutual fit among components of a system—shape of threads of a bolt and the nut, electrical bulb and socket, the side of the road cars drive on, etc. In all these cases, the specific choice is less important than the coordination among the parts. In Jamal and Tan’s (2010) experiment, the best accounting was found to occur when standards type and auditor type are mutually consistent (either both are principles-based, or both are rules-based). The argument for consistency and comparability, as well as the attempt to create a uniform definition of assets and liabilities, are coordination arguments for accounting standards (Jamal and Sunder 2014).

Financial reporting standards can also be supported by the presence of network effects (the marginal increase in the utility of a product for a user as the number of other users changes; Katz and Shapiro 1985; Ferrell and Saloner 1985).
Quality is a second motivation behind standards. Quality standards prevent many people from performing surgery, cutting hair, or teaching accounting, and are often justified on the grounds that they are meant for the protection of the uninformed patients, customers, or students who may find it costly or impossible to discriminate between the competent and the crooks. These standards, the argument goes, protect the informationally weak and enhance social welfare by promoting mutual trust and reducing the need for investment in gathering private information.

Quality standards specify a minimum for each attribute of the product category, such as percent of foreign material or impurities, strength, probability of failure, chances of defect, fat content, and smoothness. They may also specify various grades for the product (see Jamal and Sunder 2011a,b). Sellers can save money in the short run by cutting corners on quality, and buyers prefer higher quality, making it important to include the relevant quality standard in commercial contracts.

With the benefits of standards come costs, which limit the extent of standardization, and lead us to have many different models of cars, computer languages, types of doctors, and even types of electrical outlets (Krislov 1997). Four broad categories of costs are: (1) the direct costs of formulating and implementing the standards, (2) the cost of “imperfect fit” for those whose needs would be better served by an alternative to the chosen standard, (3) the potential use of standards to create monopoly and discourage competition, and (4) making experimentation, learning, and innovation more difficult.

Both the costs as well as the benefits of standards can be significant; however, while the direct costs tend to be concentrated among a few, the benefits may be thinly distributed over many parties. Since it is difficult to collect the payments from such
distributed population of beneficiaries, such work is done either by government or industry consortia. Only a small number are willing to pay a significantly higher price for a custom-fitted suit or custom-designed home instead of buying a standardized product off-the-shelf. Antitrust cases against Microsoft Corporation’s attempt to standardize its Internet Explorer software with Windows computers, and the benefits that came from proliferation of competing browsers is a recent example of anticompetitive costs. Standardization of the QWERTY keyboard in practice has shut out DVORAK and other more efficient keyboard layouts from gaining a foothold in the market place.

Problems of Identifying the Social Optimal

The uneven distribution of costs and benefits of standards render it difficult to determine which standards are socially desirable. The cost-benefit criterion (total benefits exceeding total costs) ignores the distributive effects. Pareto criterion (choose an option which is better for at least some people without being worse for anyone) is difficult to apply in practice. It is not easy to think of a law, rule, or standard that hurts nobody. Social choice mechanisms discussed in Chapter 3 often end up settling on some compromise between efficiency and distributive concerns.

The practical task of identifying which one of the proposed alternatives best satisfies the chosen criterion is a nontrivial task because the decision makers do not know the private preferences, and the attempts to discover them are fraught with strategic problems. When we ask people what standard, if any, they prefer, they may not know or they may not be willing truthfully to reveal what they prefer. Active participation in the process of standardization is also biased in favor of those who have large potential gains.
from such participation, or have relatively small costs of organizing groups with common interests to participate. Cost-benefit analyses are difficult to do; while some of the costs may be estimated, benefits of standards can be too diffused to be quantified.

Monopoly or Competition in Standard-Setting

Many arguments have been made about the advantages of monopoly or competition in setting financial reporting standards (see Dye and Sunder 2001, Sunder 2002, 2010a, and 2011a). Although regulators in some countries (e.g., Canada, Switzerland and the U.S.) allow limited competition in special circumstances, most accounting research accepts that monopoly serves public interest (Cooper and Sherer 1984). Despite predictions of a race to the bottom under competition (Barth, Clinch and Shibano 1999; Merino and Coe 1978; Previts and Merino 1998), empirical studies of regulatory competition in e-commerce (Jamal et al., 2003, 2005) and a baseball card grading market (Jamal and Sunder 2011a) failed to find it.

Direct empirical examination of the arguments has been difficult because virtually all jurisdictions operate accounting rule-making monopolies in the U.S. and other parts of the world. Jamal and Sunder (2014) go outside the domain of accounting to compare the standard setting processes of the FASB/IASB with the processes of four technology-oriented standard setting organizations (SSOs) with respect to the number of standards, role of government, financing, adoption thresholds, and competition.

By the number of standards, FASB is a relatively small player. Government participation ranges from total (ITU being an international body of national government

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7 This section is substantially based on Jamal and Sunder (2014).
8 Internet Engineering Task Force (IETF), Institute of Electrical and Electronics Engineers (IEEE), Alliance for Telecommunications Industry Solutions (ATIS), and International Telecommunications Union (ITU).
representatives) to none (IETF). While ATIS and ITU provide their standards for free on the internet, ATIS and IEEE sell their standards. FASB sells access to its standards to institutions, provides free access to students and academics, and receives tax revenues since the enactment of Sarbanes-Oxley legislation. Private SSOs are often financed by fees from members who have direct interest in their standards. Adoption thresholds are the majority (FASB and ATIS), 70% (ITU), 75% (IEEE) and a rough consensus without formal voting at IETF. Unlike the FASB, all four technology SSOs face competition.

Jamal and Sunder (2014) also conducted a case study of internet telephony to assess the role and consequences of competition in standardization. The results show that a group of IETF volunteers competing with the incumbent government-sanctioned monopoly of ITU transformed the telephone industry through highly efficient standards. With its 191 fee-paying members, a long history since 1863, and a proven track record in enabling the development of a reliable global telephone system, ITU was a success story by almost any measure. It had responded to rapid technological changes by developing a circuit switched network. Yet a revolutionary alternative—packet switched—architecture was developed by a competing standard setter (IETF) that had no government support, power to sanction, or enforce its standards. The IETF succeeded not by trying to harmonize with the ITU’s model but by having the decentralized creativity of a loosely organized group of volunteers conceiving of and designing a better “mousetrap.” Even when the incumbent SSO monopoly was doing well, a better set of standards could arise from a competitive regime because competition had not been foreclosed in advance. Given its formal structure, legacy, and billions in sunk costs by telecom companies, it is unlikely that ITU-T and the telecom industry would have ever made the leap to an
internet infrastructure without the presence, competitive pressure and insight of the IETF (Schulzrinne and Rosenberg 1998b).

The U.S. and EU have adopted a monopoly process for developing financial reporting standards almost by default, and with little debate on the merits of monopoly and competition. Consequences of this foreclosure of competition could bear some scrutiny.

Standard-setting in the United States

In the United States, the Accounting Principles Board (APB), created in 1959 as a senior committee of the American Institute of Certified Public Accountants followed a quasi-legislative model with some twenty-one part-time members. Although mostly consisting of professional accountants, it had some representatives from corporate, investment and academic communities. Like other legislatures, the Board took no action without a majority vote.

The Wheat Commission appointed by the AICPA in the wake of the investment tax credit fiasco blamed the dissatisfaction of some people with the performance of the APB on the lack of independence of its members and proposed its replacement by a quasi-judicial structure of the FASB which, however, retained the unbalanced representative character of the APB. When constituents who did not like its pronouncements complained, the FASB had little defense except to fall back on the judgment of its members. Legislative bodies do not have to defend their actions; their representative character and the partisan attitudes of their members serves as their protective cover. The AICPA's insistence that a clear majority of the members of the FASB be drawn from the ranks of practicing CPAs deprived the FASB of this defense.
The first eight years of the FASB were characterized by rapid standard setting, a willingness to recommend previously untried methods of accounting as exclusive standards, and a decline in constituent support. It was difficult for the FASB to refuse to issue standards on accounting matters brought before them. The guaranteed support of the disciplinary mechanism of the AICPA for non-compliance with the standards may have reduced their concern for acceptability by the constituencies. A large staff had to be justified by sufficient output of new rules, which also generated the revenue from the sale of publications to support them. The annual report of the FASB consisted of the lists of projects completed and the pronouncements issued as measures of performance. The atmosphere of bias in favor of action led in 1977 to relaxing of the voting requirements to a simple majority of four instead of five out of seven. The Board recommended application of complex new accounting methods which had not previously been tested in the field, and whose consequences were not well understood. FAS 8 (foreign currency translation) and FAS 19 (oil and gas exploration costs) are examples of such actions.

In the nineties, the FASB joined the International Accounting Standards Board in a project to converge in the direction of a single set of “high quality, principles-based” accounting standards for the world. The basic difficulties of justifying and achieving such a goal, combined with the reality check provided by the global financial crisis of the recent decade, has led to abandonment of that project. After some forty-plus years, and many important achievements such as accounting for pensions and other post-retirement benefits, the organization appears to have settled in with a more modest vision of the improvements in financial reporting that can be achieved through standardization.
Table 1: Process Description of Five Standard Setting Bodies in U.S. as of February 18, 2008 (Source: Jamal and Sunder 2014)

<table>
<thead>
<tr>
<th>Standard Setting Organization (SSO)</th>
<th>Financial Accounting Standards Board (FASB)</th>
<th>Internet Engineering Task Force (IETF)</th>
<th>Institute of Electrical and Electronics Engineers (IEEE)</th>
<th>Alliance for Telecommunications Industry Solutions (ATIS)</th>
<th>International Telecommunications Union (ITU)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scope of Standards</strong></td>
<td>Financial Reporting (GAAP)</td>
<td>Internet: Above the wire and below the application (e.g., IP, TCP, e-mail)</td>
<td>Aerospace, telecom especially networking electric power, consumer electronics, and Internet</td>
<td>IT in Telecom Industry such as Plant Infrastructure, Wireless, Multimedia</td>
<td>Global telecom network standards</td>
</tr>
<tr>
<td><strong>Working Groups</strong></td>
<td>12</td>
<td>124</td>
<td>102</td>
<td>24</td>
<td>14</td>
</tr>
<tr>
<td><strong>No. of Standards</strong></td>
<td>168</td>
<td>7,136</td>
<td>1,534</td>
<td>1224+</td>
<td>4000+</td>
</tr>
<tr>
<td><strong>Sanctions For Non-Compliance</strong></td>
<td>Yes from SEC</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Membership</strong></td>
<td>No direct members</td>
<td>65,000 Individuals and 150 Organizations</td>
<td>425,000 members in 160 countries</td>
<td>300 Corporate Representatives</td>
<td>193 States who can vote, over 700 private sector members with no vote</td>
</tr>
<tr>
<td><strong>Funding</strong></td>
<td>FAF collects a tax from companies (as per SOX) based on their equity market</td>
<td>Individuals and Organization pay membership fee to Internet Society. Individuals</td>
<td>Individuals and Organization pay membership fee</td>
<td>Companies pay membership fee (from $1,000-$259,000 per year) based on sales, and a standard committee fee</td>
<td>Each country pays membership fee of 63,600 Swiss Francs per year</td>
</tr>
<tr>
<td>Capitalization (67% of budget)</td>
<td>can also be “free” (global) members. Most funding comes from Companies, and various non-profit organizations</td>
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</tr>
<tr>
<td>Sale of publications (33% of budget)</td>
<td>An IEEE-approved organization must sponsor a standard by filling out a PAR form (Project Authorization Request)</td>
<td>An issue Champion—an ATIS member or a forum or committee participant must fill out an issue identification form</td>
<td></td>
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<tr>
<td>Standards Initiated by</td>
<td>FAF and reviewed by FASAC (Advisory Council) Grassroots members or Area Director (AD)</td>
<td>An issue Champion—an ATIS member or a forum or committee participant must fill out an issue identification form</td>
<td>Member states, and other duly authorized entities (national SSOs or individual companies)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Working Groups</td>
<td>Full time FASB staff workers Resource group of external participants set up to provide advice Agenda and minutes online</td>
<td>Create public mailing list – number and diversity of participants monitored by AD Agenda and minutes online Create a document called Internet Draft (I-D) prepares a draft of the proposed standard</td>
<td>Review the text of the draft Recommendation Assess the summary statement in terms of its completeness and intention Debate to approve the Recommendations.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exposure Draft</td>
<td>Written exposure draft. Public given minimum of 30 days to respond. Last Call issued by IESG with 4 weeks for outside input</td>
<td>Each member of the IEEE-SA Standards Board places a final vote on the submitted standard document An Issue is automatically placed into Final Closure provided: 21 calendar days have passed since the Issue’s Initial Closure resolution and No new information surfaces</td>
<td>The text of the draft new or revised Recommendation must be available to TSB in a final edited form in at least one of the official and working languages.</td>
<td></td>
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</tr>
<tr>
<td>Standard Adoption Threshold</td>
<td>&gt;50% votes of FASB Board members No Voting - Rough consensus as determined by AD 75% of Votes Cast, and at least 75% of Working</td>
<td>Each company has one vote. Need &gt;50% Votes</td>
<td>70% of Votes cast (only government reps can vote – one vote per country)</td>
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<td></td>
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<tr>
<td></td>
<td>group must vote</td>
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<td>------------------------------------------------</td>
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<tr>
<td><strong>Can Issue More than One Standard for same Issue</strong></td>
<td>Yes</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>- No</td>
<td>Yes- though rare in practice</td>
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<tr>
<td>- Yes</td>
<td>Yes</td>
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<tr>
<td>- Yes</td>
<td>Yes</td>
<td></td>
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</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Standard Duration</strong></th>
<th>Indefinite</th>
<th>Indefinite</th>
<th>5 years – automatic review or withdraw</th>
<th>Indefinite</th>
<th>Indefinite</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Standards Competition</strong></td>
<td>No</td>
<td>Done Ex-Post in the Market</td>
<td>Done Ex-Post in the Market, but also Sponsors some Ex-ante Olympic competition (experiment)</td>
<td>Done Ex-Post in the Market</td>
<td>Done Ex-Post in the Market</td>
</tr>
</tbody>
</table>

FASB = Financial Accounting Standards Board (www.fasb.org)
IETF = Internet Engineering Task Force (www.ietf.org)
IEEE = Institute of Electrical and Electronics Engineers (www.ieee.org)
ATIS = Alliance for Telecommunications Industry Solution (www.atis.org)
ITU = International Telecommunications union (www.itu.int/ITU-T/index.phtml)
A more detailed (and earlier) version of this table can be accessed at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1075705

References


Chapter 5: Social Norms

Historically, norms of accounting played an important role in financial reporting. Social norms are maintained largely through an informal process of social as well as internal sanctions. In contrast, rules require more formal enforcement mechanisms, often supported by implicit or explicit power of the state to impose punishment. Many aspects of family, local, professional, social, national and international behaviors continue to be governed by mechanisms in which norms play an important role. Generally accepted accounting principles—originally a mere description in its plain English meaning—have since been capitalized into a proper name—Generally Accepted Accounting Principles—and the phrase now describes rules and regulations issued by authorities with power to sanction those who do not choose to accept them. How and why did financial reporting replace social norms of corporate and professional behavior by written rules and standards? The consequences of this transformation and alternative courses that are available to accounting and corporate governance deserve attention. Whether the transition from norms to written standards is productive and wise is an open question. In this chapter we examine the role of social norms in financial reporting.

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9 Based on Sunder (2005a and 2005b).
Nature of Social Norms

Social norms of a group are the shared expectations of one another’s behavior held by the members of the group. Norms are expectations, and therefore inherently subjective. They are shared, which means that while individual $A$ expects others to behave in the given manner, $A$ also believes that others hold similar beliefs, and what applies to $A$ also applies to the other members of the group. According to Posner (1997, p. 365):

“By “social norm” (“norm” for short) I shall mean a rule that is neither promulgated by an official source, such as a court or a legislature, nor enforced by the threat of legal sanctions, yet is regularly complied with (otherwise it wouldn’t be a rule). The rules of etiquette, including norms of proper dress and table manners; the rules of grammar; and customary law in pre-political societies and private associations are all examples of norms in my sense.”

Common knowledge of $X$, in its technical meaning, is shared knowledge among two or more people so each knows $X$, knows that others know $X$, knows that everyone knows that everyone else knows $X$, ad infinitum. Wearing a coat and tie in an office is a social norm if, even in the absence of formal rules and enforcement process, and in the presence of available and convenient alternatives, people do in fact wear a coat and tie and expect others to do the same. In this sense, social norms or conventions are indistinguishable from the culture of the group (Sunder, 2002c).

The object of norms is behavior, not beliefs; which means that it is always possible for an individual $A$ to judge, subjectively, if the observed behavior does or does not conform to the norm. Social norm is a consensus—mere majority is insufficient to
support it and unanimity is unnecessary. It is also incompletely specified. Like
dictionaries and handbooks of manners, individuals or groups may compile and share
their own understanding of the norms. Such compilations may receive attention, respect,
even authority, depending on how well they appeal to the members of a group. Norms
have no other authoritative source.

Accounting Norm: An Example

Recognizing revenue when essentially all that needs to be done to earn it has been
done, and when the consideration in exchange has been received or is reasonably certain
to be received, is an accounting norm. Managers, accountants, and students of accounting
share the expectations that businesses recognize revenue in this manner. This norm, like
others, is inherently subjective. Each individual can decide, after looking at a particular
case of revenue recognition, whether it conforms to the norm. In a given instance,
unanimity may not be achieved; consensus is the best one could hope for. A complete
specification of all necessary and sufficient conditions for revenue recognition norm is
unnecessary, as well as impossible. Like other social norms, there can be no authoritative
source of accounting norms either, even as individuals and groups remain free to provide
their own statements of what the norms are.

For example, Paton and Littleton (1940) use “Standards” in the title of the book,
instead of principles in order to avoid conveying an inappropriate level of “permanence
and universality.” For our purposes, it is a statement of norms “as a personal expression
from the … score or so men who have labored earnestly to make the preparation of this
document possible” (Howard C. Greer in Forward, p. vii). As with the Oxford English
Dictionary or a book of etiquette, any authority and respect such sources may command derives not from their power to punish deviations, but from the broad acceptance by the members of the relevant community, and their general disapproval of deviations.

It has been so long since accountants turned away from norms that the authoritative promulgation of accounting practices is often assumed to be synonymous with progress or advancement of accounting. In his Lectures on Forging Accounting Principles in Five Countries, Zeff (1972, 1-2) wrote: “The English Institute became involved in the authoritative establishment of accounting principles perhaps more by evolution than deliberate policy … [I]t was not until the last month of the 1960s, however, that developments in accounting research and the establishment of accounting principles began to quicken their pace. By the outset of the 1970s, an energetic and ambitious plan was in operation.” It is easy to identify the history of accounting principles with organized efforts to produce written rules because documentary traces of such processes are more easily available for the historians; social norms, even if they are widely accepted, leave nary a footprint in the public record. We can see the evidence of norms in fiction\textsuperscript{10, 11}. However, accounting is hardly a favorite subject in English or other literature.

The long distance traveled steadily from norms towards standards can be seen in the charge the American Association of Public Accountants gave to a Special Committee on Accounting Terminology in April 1909 “to collate and arrange accounting words and


\textsuperscript{11} Waymire (personal communication) suggests that researchers have rarely ventured to examine the internal correspondence and discussions of client and audit firms where they might find the “footprints” of social norms.
phrases and show in connection with each the varying usages to which they are put. …
This committee will not attempt to determine the correct or even the preferable usage
where more than one is in existence.” (Zeff 1972, p. 112).

In 1918, a reprint of a memorandum on auditing procedures, prepared by the
American Institute of Accountants, and approved by the Federal Trade Commission
(FTC), and originally published in the Federal Reserve Bulletin, was labelled “A
Tentative Proposal Submitted by the Federal Reserve Board for the Consideration of
Banks, Bankers, and Banking Associations; Merchants, Manufacturers, and Associations
of Manufacturers; Auditors, Accountants, and Associations of Accountants.” The intent
was to coordinate the evolution of a norm, and not to impose a standard.

In the same year, the American Institute of Accountants appointed a Special
Committee on Interest in Relation to Cost to address a lively controversy on imputed
interest as part of the cost of production. The Committee’s recommendation against
inclusion of imputed interest in cost of production, and its approval at the annual meeting
of the Institute, did not become accepted as an accounting norm. The Institute went on to
appoint a special committee on the standardization of accounting procedure “to consider
all questions of procedure brought before it, and to make recommendations from time to
time on vexed questions in the hope that ultimately there may be established something
approaching uniformity of procedure throughout the country” (Zeff 1972, p. 116). Again,
the charge suggests facilitation to develop norms, not legislation of standards. During its
eleven-year tenure (1918-1929), the Committee produced six reports, and none was
submitted for an official stamp of approval of the Institute’s membership.
The absence of authoritative standards of accounting did not mean that the world of accounting had less order in the early twentieth century than in the early twenty-first. Zeff discusses several active mechanisms the accountants of the day might have used to identify the norms of their profession. First, the pages of the *Journal of Accountancy* and perhaps *CPA Journal* served as forums for active, even feisty debates on accounting and auditing; a function largely abandoned by the accounting journals over the past quarter century as authoritative standards pushed the norms out. During 1920-29, the Librarian of the Institute issued 33 “special bulletins” on topics referred to them, albeit without the authority of the Institute. In 1931, the Institute published a 126-page book *Accounting Terminology*, a compilation of accounting terms and their definitions as a matter of advice, not authority.\(^\text{12}\) Throughout the 1920s and into 1930s, a committee of the Institute worked in close cooperation with a committee of Robert Morris Associates, an organization of bank loan officers, to respond to inquiries submitted to them.

The stock market crash of 1929, and the economic depression that followed, also precipitated another crash—in the trust in norms of accounting and the formal or informal mechanisms by which these norms evolved and were sustained. So much wealth, livelihoods, even lives, had been lost for which the prevailing norms took the blame. The social contract was broken; it was time to identify and punish—or at least constrain—the guilty. Politicians responded in the only way they could and introduced securities laws and regulations to replace the norms as well as private innovation as a response to

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\(^{12}\) In his review of *Costing Terminology*, Kitchen (1954) provides a masterful argument for resisting the temptation to issue official definitions, especially in accounting. Also see Baxter (1953).
adverse events. In the following seven decades, accounting and audit failures were interpreted as evidence that norms do not work; norms were downgrades to the back burner, and legislated accounting standards rose to dominate accounting in the belief that better financial reporting can be designed top-down through expert deliberations. The creation of institutions from 1939 to the present day in the hope of accomplishing this goal is discussed in Chapter 6. We return to the problem of better financial reporting in Chapter 7.

How Do Norms Work?

How can social norms, subjective and incompletely specified, work in the contentious environment of financial reporting where a great deal of money is often at stake? Norms play an important role in law (Posner 1997, Ellickson 1998, Eisenberg 1999). Congress and the Securities and Exchange Commission, for example, refuse to write a complete specification of insider trading beyond the vague definition of “trading on non-public information.”

Unlike formal rules and regulations, motivation to conform to social norms is rooted in the anticipation, or even fear, of others’ disapproval of deviations from the norms. Social norms become so internalized by individuals that conformity to them approximates moral or ethical obligation. When sufficiently internalized, the members of the group may find it redundant to monitor conformity, giving rise to trust. A large body of literature in psychology (Cook, 2001), sociology (Granovetter, 1985), and political science (Putnam, 1993) suggests that the key trust creation mechanisms in society

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13 Also see Jamal et al.’s (2005) finding on the evolution of the U.S. web seal market to provide assurance on privacy practices in e-commerce. Under the stricter regulatory regime of the European Union, no such marker has developed.
are personal relationships and the social embeddedness of market participants rather than legal rules and formal enforcement structures.

Courts and Juries

Juries routinely decide on high stakes charges of murder, assault or fraud by asking: is the defendant guilty beyond a reasonable doubt? The law does not try to replace these norms by clear, authoritative, complete and objective statements. The U.S. constitution—a document that covers the entire governance system for the republic—was written in less than 5,000 words. The United Kingdom does not even have a written constitution. A great part of the governance of both countries depends on norms. The stakes that accountants deal with are no higher than in courts’ decisions. Yet, accountants appear intent on pursuing the displacement of norms by written rules in an endless pursuit of completeness, objectivity, and uniformity.

When a jury is asked to reach a verdict on whether the accused is guilty beyond a reasonable doubt, care is taken to minimize any conflicts of interest that its members may have. The prospective jurors are asked to reveal such conflicts, and the prosecuting and defense attorneys cull any members who may have such conflicts. Care is taken to prevent people who may be pre-disposed with respect to the guilt or innocence of the accused, and to protect the jury from unfair influences during the course of trial. When the threat of such influence exists, judges may isolate the jury to protect them. Juries are encouraged to reach a vaguely-defined objective of “beyond a reasonable doubt” but are

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14 On March 15, 2005, a jury returned a guilty verdict on all counts against Bernard Ebbers, the erstwhile chief executive officer of WorldCom, who was accused of an 11 billion dollar fraud. Post-verdict news reports quoted a member of the jury to say that she did not believe the main prosecution witness, Scott Sullivan, but did not believe Ebbers either, and found him guilty as charged.
assured that their judgment itself would not be subject to second-guessing by the judge or appellate courts. Jury’s verdicts may be overturned if its rules of procedure are violated, but not because it is unreasonable in someone else’s judgment. If accountants and managers are to retain some elements of norms in financial reporting, they also will have to develop such trust in themselves and others, and prove to be trustworthy.

Insider Trading

When the SEC decides whether to charge someone with violation of the ban on insider trading, the rules and structure of the Commission are designed to protect such a judgment from conflict of interest. If the Commission chooses to proceed with the charge, its judgment is subject to review by the attorneys in the Department of Justice, who themselves are protected through similar procedures. Finally, the Department of Justice may take the case to court, where the final judgment is rendered, in spite of a far-from-complete definition of “insider trading” as well as “reasonable doubt.”

Constitutions

Even written constitutions are far-from-complete specifications of the rules. Judgments of the courts in ill-defined environments are sustained by investing in them the final authority without appeal beyond the Supreme Court of the United States (and the Lords of Appeal in the U.K.).

In summary, government hierarchies and courts use their rules of procedures and the authority vested in them to operate effectively in incompletely and ill-defined environments. The built-in rigidities of such structures are intended to protect them from
charges of favoritism but not arbitrariness; in the absence of the former, the latter appears benign in the absence of better alternatives.

Norms in Accounting

Financial reports of publicly-held firms are prepared by corporate managers subject to review and certification by outside auditors. Over the past eight decades, this process has been regulated by the SEC under a collection of federal securities laws, to which the Sarbanes-Oxley Act was added in 2002. It is possible that interactions of managers, auditors, and regulators with conflicts of interest have rendered financial reporting unfriendly to the use of social norms during this period.

Conflict of Interest

In preparing the financial reports, professional managers are put in a conflict-of-interest position, especially when their own compensation, job retention, and reputation in the market for managerial labor is sensitive to the financial reports they prepare. In recent decades, corporations tried to solve the agency problem of aligning the incentives of managers with the interests of the shareholders by linking managerial compensation to financial reports or their surrogates, e.g., stock prices. Attempts to address the agency problem through larger performance-based bonuses intensified the conflict of interest in preparation of financial reports, increasing the difficulty of using incompletely defined social norms to guide financial reporting.

The managerial conflicts of interest were supposed to be controlled through outside audits. The choice of public accountants as outside auditors had a built-in conflict
of interest of its own. Since Certified Public Accountants (CPAs) are paid by their client organizations for the audit services, the prospects of losing the revenue can bias the judgment of the auditor, especially when the auditor operates under incompletely defined social norms.\textsuperscript{15} Until the 1970s, the existence of this conflict of interest for the auditors had been controlled by allowing them the privileges of a learned profession, such as internal self-regulation and a code of ethics that moderated open competition for business among the CPAs. With the rise of economic theories of competition over regulation, CPAs were forced to lift these barriers to competition in 1979. The quality of audit services being essentially unobservable, both ex ante and ex post, the introduction of unfettered competition resulted in lower prices, profitability, and the resultant pressure to reduce the quality of audit services. As audit firms sought to recover their profitability by selling management advisory services to their audit clients, audit services became a loss leader to get the consulting partners’ foot in the audit clients’ door. The promotion of competition in the market for audit services had the unintended consequence of exacerbating the auditor’s existing conflict of interest, inherent in the dependence on revenues from the clients. In this environment of worsening conflict of interest, auditors were no more able to exercise unbiased judgment on social norms of accounting than the managers could do themselves. Performance-based compensation for managers as well as promotion of competition in the market for audit services mutually reinforced each other in intensifying the demand for “harder” financial reporting standards to replace the “softer” social norms.

\textsuperscript{15} Not surprisingly, the original draft of the Securities Act of 1932 proposed to assign the task of auditing publicly traded firms to General Accounting Office, an arm of the U.S. Congress. Lobbying by the American Institute of Accountants persuaded Congress to entrust this responsibility to the CPAs.
Final Authority for Decision

Autonomy of decision making with no opportunity for second-guessing supports the use of norms. Autonomy does not mean there are no consequences of making errors of judgment. While the decision of a jury is not subject to second-guessing, even the jurors must think about how their decision will appear in the eyes of the litigants, the media, and their own friends, neighbors, and family. The same applies to the concerns the justices of the Supreme Court must have for how citizens might regard the court, and its individual members, after their verdict. Neither the corporate managers, nor their auditors have this luxury of autonomy. Their judgments are always subject to second-guessing by others.

Given the conflicts of interests in managers and auditors, and the consequent absence of autonomy, applying the social norms of financial reporting becomes difficult. Perhaps the procedural rigidity of a bureaucratic hierarchy—such as the SEC—could help achieve such ends. Unfortunately, this solution is informationally infeasible. Corporate reporting requires numerous judgments at every step of the way in deciding what numbers are entered into the accounting system of the organization. No centralized bureaucracy is capable of possessing sufficient operational information to be able to apply the social norms to prepare the financial reports of publicly-held firms. Perhaps one way of achieving such a goal would be to entrust the accounting function in organizations to an internal bureaucracy, charged with the pursuit of social norms, and insulated from management functions and incentives. Even the Sarbanes-Oxley Act of 2002 does not recommend that the internal accounting and auditing structures of the firm bypass the CEO and CFO and report directly to the audit committee of the board of directors, or to
an outside regulatory agency such as the SEC. Perhaps all these conditions have exerted their cumulative pressure to curtail the role of social norms or general acceptance in financial reporting.

A Dictionary and an Inventory of Accounting

Codification is the attempt to identify, organize and write down the existing customs, practices and rules into a systematic collection. Normative laws are aspirational standards not yet reached. The idea of generally accepted accounting practices started out as a code in the former sense, but has over time, been morphed into a normative code. These two kinds of codes differ fundamentally in their content, intent, and consequences. The former code is a collection, like a dictionary, based on the judgment of an individual or a group about the existing practices, understandings and expectations. Any authority such codes may command derives solely from the willingness of the population to accept it as a repository of the relevant norms.

Anyone can write a dictionary; the respect and following it commands is a matter of the collective judgment of those who use it. They may refer to it to get a better sense of what others mean when they use a word, or whether that word will be understood by others to mean what they wish to convey. Since the meaning of a word in natural languages is a social norm, it is rarely unique or precise, subject to context, and changes over time. New editions of dictionaries are published to capture such changes. Between 1952 and 1983, six editions of Kohler’s Dictionary for Accountants were published, the last one edited and renamed after Kohler’s death by William W. Cooper and Yuji Ijiri. It constitutes an example of an attempt to codify the social norms of accounting. Paul
Grady’s Inventory of Generally Accepted Accounting Principles for Business Enterprises (1965) is another such example. 16

In the Preface to his Inventory, Grady (1965, p. ix) explicitly states his mission:

As the word inventory suggests, the task was not a mission to discover new or improved accounting principles. It was rather an undertaking:

1. To discuss the basic concepts to which accepted accounting principles are oriented;
2. To establish a list or summary of the accounting principles (or practices) now regarded as essential to the fulfillment of fiduciary accountabilities of a business enterprise to persons who have invested in the enterprise or have other bona fide interest in its financial position and results of operations;
3. To present the opinions of the Accounting Principles Board (APB) and its predecessor committee and other authoritative accounting pronouncements, now in effect, analyzed in a manner reasonably related to this summary of generally accepted accounting principles; and
4. To supply the explanatory and connecting language needed to create a practical accounting codification for the use of business enterprises and certified public accountants.

Grady’s intent of facilitating the formation of accounting norms through his compilation was rooted in the report of the special committee on research program, as modified and approved by the Council of the American Institute of CPAs, which said, in part:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles for the guidance of its members and others. This means something more than a survey of the existing practice. 17 It means continuing effort to determine appropriate practice and to narrow the areas of difference

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16 It is only appropriate to point out that the definition of norm in Kohler’s Dictionary is given as “An Authoritative standard; a rule”; standard is “A mode of conduct of general application arising from convention or advocated or imposed by higher authority” while rule is “An order, directive, or instruction usually detailing something to be done or a prescribed operation.” The Dictionary’s definition of convention emphasizes a “rule of practice which, by common consent, expresses or implied, is employed…,” and comes closest to the sense in which the term norm is used in this monograph.

17 The Institute did, of course conduct and publish periodic surveys of existing financial reporting practice under the title Accounting Trends and Techniques. This practice continues to this day and the 64th edition was published in 2010.
and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and it should, take definite steps to lead in the thinking on unsettled and controversial issues. (Grady 1965, p. x).

The Institute, and Grady seemed to have in mind a kind of compilation and facilitation which might draw, but not push, people into expanding the areas of agreement—an organized effort that does more than Miss Manners, but does not go as far as Academie Francaise does to define, protect, control, and promote the French language.

Norms or standards

At the beginning of the 21st century, few people seem to be aware of the social norm, convention, or common law approach of the earlier era, and such an approach has hardly any advocates left. While Hatfield (1927, pp. 537-539) cites 131 legal cases, FASB and SEC’s pronouncements have crowded the common law out of the U.S. textbooks. The U.S., followed by many others in the world, now favors the more formal legislated standards (with legal enforcement) model for financial reporting. Yet, the evidence that formal standards do any better than social norms of financial reporting remains elusive, and the case for the efficacy of enforced standards remains to be made. At the very least, we should not proceed with the assumption that standards dominate social norms. It may be better if, in the absence of evidence, the benefit of doubt goes to Thoreau’s motto: “that government is best which governs least.”

18 Thoreau [1849, Civil Disobedience, first paragraph]: “I heartily accept the motto,—‘That government is best which governs least;’ and I should like to see it acted up to more rapidly and systematically. Carried out, this finally amounts to this, which I also believe,—‘That government is best which governs not at all;’ and when men are prepared for it, that will be the kind of government which they will have. Government is at best but an expedient; but most governments are usually, and all governments are sometimes, inexpedient.” Also, see Emerson [1844, Politics]: “Hence the less government we have the better—the fewer laws and less confided power.”
Written standards with formal enforcement are concrete and salient. Extant standards are published, easily disseminated, specified formally with some precision, and can be cited, analyzed and discussed line and verse. They come into existence at a specific time, through a known and understood institutional process that may allow the participation of the constituents. When the environment changes or the standards are no longer perceived to induce the desired patterns of behavior, a systematic process is available to formulate changes and submit them to a well-specified process for possible promulgation.

A transparent institutional mechanism for setting and modifying standards holds a natural appeal in a democratic polity. Following accidents and scandals, “the rules were not clear” is a popular defense for scoundrels and managers who have not adopted good data handling practices. Codification of standards—let us make the rules clear to all—is a frequently chosen response to calm the political waters. Formal written standards also appeal to our sense of good housekeeping.

Social conventions and norms are less well defined, vary in time and space, and require an extended socialization process to learn and understand (Coleman, 1990). Conventions carry a penumbra of uncertainty about the edges; there is substantial but incomplete overlap among the beliefs of the individual members of a group about its norms. Even with a unique definition in time or place, norms evolve in small, almost

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20 In response to William Z. Ripley’s Atlantic Monthly (September 1926) article, “Stop, Look, Listen!” accusing large corporations of dishonest and deceptive financial reporting practices, even George O. May said: “… it seems to me that the extension of the independent audit, accompanied by a clearer definition of the authority and responsibility of auditors, is one of the most valuable remedies to be found for the defects of which Professor Ripley complains…”. May was an influential leader of the U.S. accounting profession and seemed to favor norms over standards.
imperceptible steps, by processes that are neither observable nor well understood. The evolution of norms is decentralized in the extreme, and even experts find it difficult to know which rules or practices are better, and to predict their future direction. While the evolutionary process is not opaque, the lack of definition and our poor understanding of how norms evolve make them less transparent. Scandals and crises, when they occur, mock the claims of expertise and efficiency required to legitimize existing institutions. It is hardly surprising, then, that during periods of crisis, political or bureaucratic decision makers feel pressure to replace market and social processes and write new standards instead of relying on existing (recently discredited) norms and business practices. As Paton and Littleton (1940, p. 5) point out:

“Obviously, rules become individualized and tend to vary among different enterprises under the influence of different ideas of convenience, effect of alternatives, etc. Within a given enterprise they are apt to change slowly since persistence in the continuance of established rules adds materially to the ability of interested parties to interpret accounting data correctly. In would be fruitless, therefore, to attempt a codification of rules and absurd to expect the conformity of all types of enterprise to the same methods if a codification of rules were attempted.” (Paton and Littleton, 1940, p. 5).

Beliefs about Enforcement and Effectiveness

When dentists install braces, they are careful in applying only a carefully calibrated amount of pressure to align the teeth. As teeth move and the pressure eases, they adjust the braces every few weeks to raise it again. Through experience, they have discovered that, beyond a certain limit, applying greater pressure simply results in increasing the resistance of the body tissue, and yields less satisfactory results.

In law, maximizing the punishment for an infringement is not necessarily the best way of minimizing the frequency or the extent of infringements. All threats of
punishment elicit resistance; the greater the punishment, the greater the resources devoted
to evade punishment. One may be perfectly willing to pay a $15 fine for an expired
parking meter on a city street, but a $1,000 fine is more likely to induce a visit to the
courtroom and hiring of a counsel.

Over recent decades, the enforcement powers behind the accounting standards have
been raised to progressively higher levels, driven by the belief that greater the power of
enforcement behind the written accounting standards, the greater the expected
compliance. Starting from the professional judgment of accountants, requirements of
authoritative support, conformity to written standards, internal control requirements of
the Foreign Corrupt Practice Act of 1977 and the Sarbanes Act of 2002 have been added
in steps. These attempts at better enforcement have been accompanied by an increase in
the resources devoted to avoidance of detection and punishment of infringements. As a
result, the sense of personal and professional responsibility for fair representation on the
part of corporate managers, accountants and investment bankers has given way to an
“anything that is not prohibited must be acceptable” attitude. Standardization of
accounting over the recent decades seems to have been driven by the belief that higher
the power of enforcement behind the written accounting standards, the greater the
expected compliance. Evidence in support of this belief is unclear.

Formal enforcement of informal social conventions is difficult outside a common law
system. However, social relationships among business participants make it possible to
create a “word-of-mouth” mechanism where feedback and reputation can be enhanced (or
damaged) rapidly, and a sense of community can be formed among interested parties (see
Bernstein, 2001 on the example of cotton trade). New Internet technologies make it possible for people to significantly expand these social networks (Dellarocas, 2003).

The idea of social norms works not only within countries but internationally. The human rights movement has been a major force in changing government policies in many parts of the world. The U.S., so zealous in guarding its sovereignty against international encroachments, seems to be yielding to evolving international norms on the death penalty for minors and mentally disabled offenders. On March 1, 2005, the U.S. Supreme Court abolished the death penalty for those under 18 when they committed their crimes. By doing so, “the self-proclaimed beacon of freedom in the world parted company of China, Congo, Iran, Nigeria, Pakistan, Saudi Arabia, and Yemen—the only other countries in the world that executed minor offenders” (Economist, 2005). Perhaps the U.S. Supreme Court yielded to the pressure of slowly evolving international norms. Although the death penalty remains in place for adult murderers, the U.S. is still out of step with most of its friends, and may yield to international norms in the future.21

With all its apparent advantages of clarity, explicitness, and the power of enforcement, the standards approach also suffers from several disadvantages relative to the evolutionary or social convention approach to regulation. Inductively derived accounting principles (see Littleton, 1953, chapter 11) have yielded ground to the idea

21 The Economist (2005): “In the Supreme Court’s majority opinion, written by Justice Anthony Kennedy, the court acknowledged “the overwhelming weight of international opinion against the juvenile death penalty”. While the court explicitly said that foreign opinions, legal or moral, are not binding in American law, they were nonetheless “respected and significant confirmation” for Tuesday’s ruling. … But it is not the first such case. In the 2002 ruling in Lawrence v Texas, the Supreme Court struck down a state statute forbidding private homosexual conduct. The court ruled that: “Where a case’s foundations have sustained serious erosion, criticism from other sources is of greater significance…[T]o the extent Bowers [a previous case that had upheld the anti-sodomy law] relied on values shared with a wider civilization, the case’s reasoning and holding have been rejected by the European Court of Human Rights, and other nations have taken action consistent with an affirmation of the protected right of homosexual adults to engage in intimate, consensual conduct.”
that they can be deduced from some basic assumptions or axioms (e.g., FASB, 1978; Bullen & Crook, 2005; Dopuch & Sunder, 1980 and Bromwich, Macve & Sunder, 2005). 

In the following section we examine these issues in the context of e-commerce; much of what we have to say is also applicable to financial reporting.

Norms versus Standards in E-Commerce

How can we know if a switch to a regime which places greater emphasis on norms and less on standards would work? We cannot be sure, but we can learn important lessons from historical experience in accounting, as well as in other aspects of our social experience including e-commerce, drugs and alcohol abuse, and law. When visiting e-commerce sites, few people actually read the fine print of their privacy policies. Few people read the license agreements of software. As with financial reports, attitudes towards privacy on the internet hardly distinguish among sites. This tendency generates an externality among internet transactions across sites, as well as among financial analyses across reports of various firms. While the individual amounts involved in the internet purchase transactions, and the financial investment transactions may differ by orders of magnitude, the externality issues between financial reporting and internet commerce have significant similarities; a claim that they are the same would be an overstatement.

Waymire (personal correspondence) suggests that the problem may lie in the fact that most people find it harder to understand and appreciate spontaneous processes (Hayek 1988); Cartesian perspective of explicitly designed processes and outcomes is more easily comprehended.
The U.K. (and the European Union) protect the privacy of their citizens by legislating standards to be monitored and enforced under the powers of government. The U.S. chose, through deliberation or default, to let the privacy policies in e-commerce evolve as norms or conventions without legislated standards or a punitive enforcement mechanism.

Jamal, Maier and Sunder (2005) compared the performance of these two regimes with respect to two aspects of privacy. They found that the number of email messages sent to those who do not give consent to receive such messages, is almost identical under the two regimes. Most e-commerce sites honor the choice exercised by the registrants. Registrants who indicate their willingness to receive commercial email messages receive a comparable level of message traffic under the two regimes (Exhibit 1).

They also report that on the notice/awareness dimension (i.e., participants receiving timely notice of an entity’s information and privacy policies), the overall performance of the standards and enforcement regime of the U.K. is about the same as that of the evolutionary regime of the U.S. (Exhibit 2).

In the absence of legislated standards and their government enforcement, a market for web assurance services, including privacy assurance, has arisen in the U.S. About a third of the U.S. websites chose to pay a small fee to the sellers of such services (e.g., TRUSTe and BBB Online) and had them certify that: (1) The website policies conformed to the privately developed standards of the assurance service provider, and (2) The website practices conformed to the website’s stated policies (See Jamal et al., 2003). On the whole the U.S. websites that displayed the service providers’ assurance seals performed as well or better than the U.K. websites in protecting the privacy of their users. The legislation and enforcement mechanisms in the U.K. and the European Union were set up.
on the assumption that they would help improve privacy on the Internet. Yet, the comparative study of the U.K. and the U.S. reveals that privacy has fared no better in the U.K. than in the unregulated U.S. e-commerce environment. In particular, formal regulation does not provide protection from the extreme behavior of a few websites. This is consistent with what we observe in financial reporting: Enron, WorldCom, Fannie Mae, and other companies were mired in massive accounting scandals in the most extensively regulated financial reporting environment in the world.

Limits of Standards and Rules

Legal scholarship and practice is careful in recognizing the limits of the efficacy of written rules. When it is not possible to write a rule that will improve the state of affairs compared to a judgment-based system, the law leaves the judgment in place, irrespective of the importance of the question at hand. When a judge asks the jury to determine if the accused is guilty beyond a reasonable doubt, lay jurors would want to know how much doubt is reasonable: ten percent, two percent, or one percent? The law does not attempt to codify answers to such questions. Legislators and lawyers understand all too well that the consequences of clarifying such questions can be even less desirable than the consequences of leaving the answers to judgment, even when the judgment is to be exercised by laymen. Similarly, the SEC and U.S. Congress refuse to clarify the definition of insider trading beyond “trading on non-public information.” Again, the consequences of clarifications are even less desirable than the consequences of leaving such matters to ex post judgment.
Endless clarification of accounting rules to the point of defining the percentage thresholds for materiality, lease capitalization, consolidation, and non-consolidation of special purpose entities, makes it child’s play for the Wall Street bankers, accountants, and lawyers to design transactions to frustrate the intent of the standards, no matter how carefully they have been drafted. Setting up accounting institutions such as the FASB and the IASB, whose sole function is to issue new accounting rules, has contributed to the tendency to write standards which are “generally accepted” only in the sense of “follow them, or else….!” Accountants could borrow some wisdom from the law, abolish the rule-making monopolies in various jurisdictions, and introduce elements of competition among rule makers within each financial reporting jurisdiction in order to avoid this problem (Dye & Sunder, 2001; Sunder, 2002a and 2002b).

In financial reporting, the legal requirement of an independent audit of publicly-held firms seems to serve as an obstacle to the efficient functioning of a market for audit services. If independent audit were not a legal requirement, firms with sufficient confidence in their accounts and in their prospects would spend the money to hire reputable independent auditors to convince their shareholders about their transparency and good prospects. Firms without such confidence will not find it worthwhile to hire such auditors. Investors, presented with reports with and without auditor certificates will have to make their own risk assessments and price the securities accordingly. Without government regulation, a market for certification or audit services would develop analogous to the U.S. market for web services in e-commerce. Jamal et al. (2003) adduce evidence of a web certification market for privacy assurance. DeWally and Ederington [2006] analyze the evolution and functioning of an audit certification service for online
comic book auctions on eBay. Instead of allowing such a market to develop endogenously, the SEC requires all firms to have their reports audited and, following the Sarbanes-Oxley Act, tries to specify (through the Public Company Accounting Oversight Board) the standards by which the auditing must be carried out. It can be argued that the extensive regulation of audit practice has been accompanied by commoditization of the audit and has contributed to the widespread auditing scandals of the recent years.

In the absence of mandated standards, U.S. websites tend to view the disclosure of privacy policies as an instrument of their marketing strategy to attract consumers. Accordingly, they make it easy to find their statements of policy and adhere to these policies reasonably closely. U.K. websites, on the other hand, appear to view privacy disclosure as merely a compliance matter; they appear to be, at the very least, indifferent to consumer concerns about their privacy policies; and on average, make it more difficult than in U.S. for their customers to find their statements of policy.

Dye points out that in a stationary environment standards and norms are likely to coincide.23 On the other hand, is it faster and less error prone for informal norms to evolve in response to the changing environment? There isn’t enough evidence yet about the relative abilities of law and social norms to respond efficiently to environmental changes. Sunder (1984, 1988 and 1997) suggests stability of standards as a desirable feature of the accounting environment, other things being the same, so that people have the opportunity to adjust their behavior and arrive at a steady state if no transactions innovation occurs. However, the existence of a standard setting mechanism encourages,

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23 Personal communication. Posner (2003) suggests that following precedent tends toward efficient practice and Gennaioli & Shleifer (2005) show that while convergence to efficient rules occurs only under special circumstances, the results of following precedent are more beneficial on average under more plausible circumstances.
indeed invites, interpretive innovation as well as transactions innovation. This stimulation of demand for standards is less likely to arise in a regime of evolving norms. Deviant managers and accountants would have to contend with the uncertainty of ex post resolution of whether their acts are judged to be acceptable. By trying to "make the rules clear" in advance, the FASB and the IASB encourage both transaction as well as interpretive innovation, paradoxically making it less likely that we shall ever arrive in a steady state of an ideal set of standards, even if the economic environment were to remain unchanged.

This belief is reinforced by Cheit's (1990) comparison of protective standards written by four pairs of public agencies and private organizations operating in the same space: grain elevators, woodstoves, aviation fire safety, and gas space heaters. He questions the economics and political science theories (e.g., Stigler, 1971; Wilson, 1980) about the relative nature and efficacy of safety standards set by government agencies and private organizations, and he finds little evidence to support any of them in the field data. He shows that hundreds of little-known organizations (e.g., Underwriters Laboratories and the National Fire Protection Association) follow rigorous due process, and their standards play significant roles in regulation, directly, as well as through incorporation, into government laws and regulations. We need to learn a lot more than we now know about the similarities and differences between standards setting in the public and private sectors.

The same regulatory space is often occupied by both government and non-government organizations with little systematic evidence on the circumstances in which one kind of standards is more desirable than the other. Kelman's (1981)
comparative study shows that two seemingly different regulatory regimes of workplace safety and health in the U.S. and Sweden produced surprisingly similar results. There seems to be no body of theory or evidence to guide policy makers in choosing between public and private mechanisms for a given standards and regulatory task.

Making a choice between standards and norms, and defining the extent of their respective roles in financial reporting, are not easy tasks. Standard-setters find it difficult to know which standards are superior, and what are to be the criteria for ranking the alternative standards. Corporate cost of capital is perhaps more defensible than others (see Sunder, 2002a and b); however, being an ex ante concept, it is difficult to measure with sufficient precision. Societies that depend on norms and tradition often get stuck in inefficient solutions (e.g., slavery) and it may take reform movements, even armed uprising, to release them.

Recent research in banking (Barth, Caprio & Levine, 2004) and securities regulation (Romano, 2002; La Porta et al., 2003) examines the possibility of regulatory failures, especially when public as opposed to private enforcement is the primary instrument of regulation. In financial reporting, the Securities Act of 1933 and the Securities Exchange Act of 1934 imposed an accounting regulator (the SEC) as well as a mandatory requirement to have an independent audit. The simultaneous imposition of both requirements has led to a general perception that enforced standards of accounting and a market for auditing services are complementary. Instead, accounting regulation and auditing may be substitutes. Commoditization of the financial statement audit may have been speeded up by
extensive regulation of financial accounting. A recent attempt by the audit profession (American Institute of Certified Public Accountants [AICPA]) to divorce auditing from accounting (hence the move from audit to “assurance services”) is also consistent with the argument that extensive regulation of financial reporting reduces the demand for auditing. The link between regulation of financial accounting and private demand for auditing may not be as direct, as is often assumed in the accounting literature.24

Recent decades have seen a revival of the old debate about the degree to which financial reporting should rely on detailed rules versus broad principles of accounting. Any shift in the emphasis between rules and principles implies a corresponding change in reliance on formal enforcement and norms of behavior. The consensus seems to be shifting toward placing more weight on principles. The findings of the Jamal et al. (2005) study that raise questions about the effectiveness of enforced law in enhancing e-commerce privacy can be usefully considered in this light.

Law, auditors, reputation, business norms and practices, warranties, disclosure, and industry associations are various trust-creation mechanisms associated with markets. The value of each mechanism depends on which other mechanisms are available in a particular market. Although each mechanism may be useful in isolation, the marginal value of some over others may be small. Perhaps the

24 The AICPA and the Big 4 accounting firms failed to penetrate the e-commerce privacy assurance market, which is currently dominated by TRUSTe and BBB Online. The AICPA focused its online Web seal (WEBTRUST) on selling assurance with respect to business practices (internal control) and security, not privacy, and found that there is little demand for what they offered at the high prices they demanded. DeWally & Ederington [2006] document a thriving market for quality assurance services for comic books sold on eBay. Although eBay designated PepBoys as its official assurance provider for used cars sold on its system, the demand for this service appears to be small.
value of legal regulation and enforcement may be overestimated when the availability of alternative trust generation mechanisms is ignored in studies of accounting regulation. Future research can help us understand the incremental value of formal legal regulation and enforcement in situations where other trust-creation mechanisms are available.

By their very nature, social norms (and culture) are specific to the society they serve. Variations in evolved systems, like in the beaks of the finches inhabiting various valleys of the Galapagos Islands, or in wedding ceremonies in various parts of the world, are not explainable entirely in terms of identifiable factors. Random chance and history also play a role. Attempts to harmonize financial reporting across the world assume that all cross-country variation in financial reporting practices is random or at least that the advantages of dispensing with such variations exceed any reduction in the fit between the local economic environments and the financial reports. The practices proposed for universal use are those prevalent in the English-speaking countries, especially the U.S. and U.K. Such ethnocentricity would be rejected in most other fields of social sciences but it has remained largely unchallenged in financial reporting.

Is it possible to tame the financial reporting practices of corporations through substantial, if not exclusive, reliance on written rules and punishment for violations? While the standard setters erect short sections of fence in the vicinity the lion was last spotted, the compensation committees of the boards throw red meat of juicy compensation packages tempting hungry animals to skirt these flimsy barriers in the open jungle of financial reporting. Evidence on behavior of social animals
suggests that beyond their physical needs, constraints and threats, norms of their own society play a significant role in what they do. Perhaps it is not unreasonable to wonder if, given the importance of our own extensive and complex social structures and norms in various walks of life, ignoring them in financial reporting is a wise choice.

Possible Reforms

The pendulum of corporate financial reporting appears to have swung too far in the direction of written rules. Perhaps it is time to achieve some shift in emphasis of financial reporting from standards towards social norms by addressing the factors mentioned in the preceding sections. These are discussed in Chapter 7.

References


Exhibit 1: Average Number of E-mail Messages Generated Per Week
(Source: Jamal, Maier & Sunder, 2005)
Exhibit 2: Notifying Visitors: Disclosure of Privacy Policies on U.S. and UK Websites
(Source: Jamal, Maier & Sunder, 2005)
We can think about institutions of accounting at organizational, structural, and expectations levels. Organizations such as the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB) and the Public Company Accounting Oversight Board (PCAOB), and National Association of State Boards of Accountancy, etc., come to mind. The presence and functioning of such institutions is seen in their charters, buildings, employees and other active participants, budgets, procedures, and activities. Structural institutions exist at a more abstract level such as business corporations, the accounting profession and higher education in the U.S. Structural institutions consist of operating relationships among many organizations and individuals defined and governed by law, regulations, social norms, technology, and preferences.

At a higher level of abstraction, expectational institutions come into view. For example, in family, citizenry, marriage, language, festivals, and religion are labels assigned to certain expectations and observable and recurring patterns of behavior in societies. They also are called institutions in a third sense of the term. This three-way classification of institutions is hardly mutually exclusive, but little would be gained by attempting a more precise delineation of boundaries to separate them. In discussing social norms in Chapter 5,

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25 Based on Sunder (2003).
Evolution

Accounting and auditing are important components of the corporate institution that has evolved over the four centuries since the Dutch and the British East India Companies were chartered (Dobija 2015). These companies grew into joint stock companies to gather large amounts of capital from investors to finance trade with the rich countries to the East along the newly discovered oceanic routes.

When a person entrusts his wealth to another in the hope of benefiting from the latter’s investment expertise and skills, the risk of malfeasance comes with the prospect of returns. These companies, too, faced this agency problem, and experimented to find a satisfactory arrangement to balance the interests and incentives of the principals and the agents. Institutions of accounting and auditing evolved to support the function of organizations. Reports of continuing malfunctions show that the solutions developed are far from perfect, even unsatisfactory (Peterson 2015). I examine some possibilities for reforming the institutions accounting to do better.

U.S. Corporate accounting

Consider four main elements of the U.S. system—accounting rules, organization to set accounting rules, audit requirement along with a mechanism to control the quality of audit work, and the involvement of the board of directors in audit and financial reporting of the
firm. A fifth element—executive compensation—is also crucial for the analysis of the institution of corporate accounting.

Managers of publicly held corporations and not-for-profit organizations have to prepare, publish, and vouch for their financial reports, at least once-a-year. Allowing some discretion in content and format, these published reports are required to be supported by a system of accounting and internal controls to safeguard the resources of the organization. In addition, the reports must meet some minimum standards of disclosure, detail, definitions, and measurement. We refer to all these as accounting rules.

The statutory authority for setting the accounting rules lies with the Securities and Exchange Commission (SEC), an independent regulatory body set up by the government to implement acts of Congress. The SEC lets the FASB, a tax-financed private organization, do the detailed work of developing standards through a laborious process, and retains a right to veto its outcomes. Publicly-held corporations are required to follow these accounting rules through the statutory enforcement power of the SEC.

The SEC also requires that the financial reports be certified by CPAs to fairly present the company’s financial status and performance. The CPAs who do not have a reasonable basis for issuing such a certificate risk being held liable to the shareholders for negligence. The AICPA’s elaborate rules to guide its members in their audit work were replaced in 2002 by PCAOB created by an act of Congress. PCAOB also oversees the functioning and disciplining of audit firms.

The New York Stock Exchange requires its listed firms to have a majority of their board members to be independent in the sense of not being employed by the corporation. It also
requires the audit committee of the board consisting of independent directors to supervise the appointment and work of the outside auditors. Field observations, however, reveal major gaps between these requirements and actual practice (see Fiolleau et al. 2013).

A large part of the compensation of corporate executives is contingent on corporate performance as measured by accounting numbers (e.g., income, sales, and the rate of return) or stock price returns. The granting of stock options has become an especially popular form of contingent compensation, its popularity fuelled by an accounting rule that excluded the economic value of options from compensation expense recognized in the income statement. The magnitude of the contingent compensation can be large, and in some cases it has reached hundreds of millions of dollars for one person for one year. The decisions about executive compensation are made by the compensation committee of the board of directors consisting of members who are supposed to be independent of the management. But typically, these “independent” members of boards depend on the goodwill of the CEO for their own compensation and perks.

This rough outline of the accounting institution for business corporations can be used as a point of departure to explore the feasibility and consequences of alternative structures.

Accounting Rules

Until the early 1970s, general acceptance was the dominant accounting paradigm. Like natural languages, where the meaning arises from general acceptance, accounting was thought to evolve gradually through usage, analysis, discussion, and soft recommendations over time. The multiple shades of meaning associated with each word and the multiplicity of words to convey
various shades of a given meaning, endow natural languages with flexibility and depth of expression. Natural languages have their grammar and dictionaries written by those whose authority is derived not from their power to sanction, but from the recognition of their expertise. No natural language is known to have been designed by people through a deliberative process; Esperanto, created to become the universal language, has languished in obscurity (Fearnley and Sunder 2006).

Since the creation of the SEC, the evolutionary spirit underlying the general acceptance tradition has been de-emphasized in favor of designing accounting rules through a deliberative process, and enforcing them through sanctions. The efforts of the Committee on Accounting Procedure (CAP) during 1939-59 was modestly labelled as Accounting Research Bulletins, implying that they were tentative suggestions at most, of some experts who had researched the matters. While the intent of CAP was clearly to nudge the evolution of GAAP, and perhaps even codify some of the extant accounting practice, the labels of the Committee as well as its writings were modest about the importance, abilities, and attention they deserved.

After some twenty years, the Accounting Principles Board (APB) and its Opinions replaced the CAP and the research bulletins. Stepped up assertiveness is reflected in the name of the organization—a board that identifies the principles, beyond conducting just research. However, it stopped short of claiming anything more than the label of Opinions for its endeavors. While these Opinions carried significant weight, they left room for others to have different opinions. Indeed, in practice, CPAs could and did deviate from the published Opinions of the Board when they thought it appropriate for fair presentation in financial reports of their clients, without risking sanctions.
The failure of the APB to gain general acceptance for its *Opinions* on accounting for investment tax credit led the SEC and the accountants to infer that more authority to back up the accounting rules would solve the problem. They created the FASB to issue *Financial Accounting Standards*. Corporations and CPAs were required to adhere to the FASB standards at the pain of sanctions and penalties. Armed with a large permanent establishment and budget, the FASB ventured forth to pronounce the rules that corporations and CPAs have been required to follow. The authority vested in the new body discarded the idea of general acceptance; its seven members were to decide on the accounting rules after analysis, research and consultation.

The FASB listed many criteria for the selection of its accounting rules in its *Concepts* statements, many of them necessarily in conflict with one another. An aggregation function, or a method to resolve these conflicts was missing from the *Concepts*. The Board set up an elaborate and good faith consultative process to elicit suggestions, comments and advice from its constituents before making its pronouncements. Unfortunately, the authority vested in its pronouncements deprived them of evolutionary organic characteristics necessary for general acceptance implicit in living languages.

Instead, the existence of the FASB became an instrument for auditors to replace their judgment by requests for clarification of the Board’s rules so they could be applied mechanically. Worse, the FASB’s standards became the opponent in a game of hide-and-seek played jointly by corporate managers and their financial engineers from banks and audit firms (see Sunder 2011b; Dye et al. 2015; Glover 2013). The intended solution had turned into a problem. In the aftermath of the Enron and related controversies, the criticism that the FASB was developing rules rather than principles-based accounting appeared as a cruel joke after three
decades of hard work by the Board. What is worse, this criticism came across the Atlantic from those who would have liked nothing better than to have matched the thickness and the detail of FASB’s rulebook if only they had had the time and resources to do so.\(^{26}\)

Standard-setting bodies carry a difficult brief. Even if they knew the criteria for desirable rules, it would be difficult for them to know which rule or rules best fulfill the chosen criteria. The advice they receive is largely self-serving. Information on the consequences of alternative rules, especially the newly-minted ones, is almost impossible to get. Comparative studies from the field require competition among alternative rules. A global monopoly of a single set of standards will make it virtually impossible to gather data from the field to support informed choice of rules after considering the consequences of alternatives. Poorly chosen rules will persist because any challenges to the choices made by a monopoly rule-maker will become so much more difficult to support by data in a world without alternative practices.

The standards approach to accounting has the advantage of speedy action in response to changing conditions combined with the disadvantage of the risk that the action makes things worse, not better. A standard-setting body can be likened to a fire brigade, standing ready to deploy its expert resources to address any perceived abuses in financial reporting and come up with a rule that might block them in the future. It is not an effective instrument for anticipating how the targets of such blocking actions will react, and whether the ultimate outcome of their behavior after they have adjusted to the new rules will be more or less desirable than the status

\(^{26}\) The International Accounting Standards Board (IASB), with over hundred member countries, is the biggest and the most consequential adoption of the idea that accounting should be guided by rules framed by a deliberative body, instead of principles that may evolve through practice and their general acceptance. IASB’s insistence on being “principles-based” appears silly when one searches in vain for other learned professions whose principles take over three thousand pages to articulate.
Many well-intentioned accounting standard-setting projects have foundered on the rocks of this action-reaction sequence between rules and managerial behavior.

Recognizing the economics of this game, managers, investment bankers, and lawyers play with the accounting rules, presenting a dilemma to the rule-makers. The rule-makers can analyze the likely consequences of the game by assigning motives to the players. For example, the managers may be assumed to maximize the present value of their personal compensation over their careers, and the investment bankers may be assumed to maximize the present value of their fees from transactions. While perfectly understandable in private domains, such analyses are difficult to reconcile in public with the pretense of professionalism. The rule-makers cannot question such private motives to their constituents without having their own personal motives subjected to similar scrutiny. Instead of washing all this dirty linen in public, both the rule-makers as well as their constituents engage in a ritual dance of nuanced language and actions where everyone pretends that everyone is working in the best interests of the public—especially the investing public—and avoid serious analysis of the real motives, alternative options, and implicit threats of the players in the game.

The existence of a permanent standard-setting establishment weakens the auditors’ ability and willingness to use their judgment. Under pressure from the clients, they are pressed to petition the rule-maker for “clarifications” of the rules already on the books. There is no rational basis for the rule-maker to select some of these requests for compliance. Sooner or later the number of such requests that end up on the agenda is limited only by the budget and schedule of the rule-makers. After all, the rule-making organization itself needs items for its agenda in order to remain in business. A permanent establishment and progressive “clarification” of the rules
reinforce each other. The rulebook grows thicker; and the question of whether the financial reports that result from such rules fairly represent the status and performance of the organization gets buried deeper under the procedural thicket. Even if the auditor or the manager doubts the fairness of a financial report, he would have to choose between the letter of the concrete rules—which he is required to follow under the threat of sanctions, and their spirit—which is a matter of judgment and vaguely specified consequences. It is hardly surprising that the auditor prefers the letter to the spirit of the rules.

After Enron and other financial reporting scandals, there has been much discussion about doing accounting by rules versus principles. A permanent body for writing accounting standards, which will stick to the principles without getting into the detailed rules, is an oxymoron. Setting up rule-making committees and boards is the easy thing to do. Many countries followed the U.S. lead in doing so. It is hard to argue against the rule of law in accounting, backed by enforcement authority, in a democratic system of government.

The concept of common law developed in England through custom, acceptance and judicial precedent. According to Landry, “Common law is law that comes from the common people, vers., legislation, which, comes from the "experts." “…their Authoritative and Original Institutions are not set down in Writing in that Manner, or with that Authority that Acts of Parliament are, but they are grown into Use, and have acquired their binding Power and the Force of Laws by a long and immemorial Usage, and by the Strength of Custom and Reception in this Kingdom. The Matters indeed, and the Substance of those Laws, are in Writing, but the formal and obliging Force and Power of them grows by long Custom and Use, as will fully appear in the ensuing Discourse.” They are available “… for the most part extant in Records of
Pleas, Proceedings and Judgments, in Books of Reports, and Judicial Decisions, in Tractates of Learned Men's Arguments and Opinions, preserved from ancient Times, and still extant in Writing.” Hale (1713).

It is useful to reconsider the merits of the common law approach after the results we have obtained in the recent decades. While the common law approach is not acceptable in toto, we may consider allowing at least a few alternative sets of accounting standards to compete within each jurisdiction.

**Auditing**

The Securities Exchange Act of 1934 required the publicly-held corporations to have independent outside auditors certify the fairness of their financial reports. Though an early draft of the legislation assigned this duty to the General Accounting Office (GAO), an oversight branch of the U.S. Congress, the Col. Arthur H. Carter of the New York State Society of Certified Public Accountants persuaded Congress to give the audit franchise to CPAs. Mandatory audit by CPAs has remained the practice for eight decades. Both components of this audit institution—the mandatory requirement, as well as the exclusive franchise to conduct such audits granted to the members of a private organization—deserve scrutiny.

**Mandatory Audit**

Publicly held corporations often employed independent audits long before the 1933 law made them mandatory for all those who chose this form of business organization. It is understandable that audits conducted by independent outside auditors help inform the investors about the
integrity of the certified corporate reports. The imposition of such a legal requirement in the aftermath of the business scandals of the late nineteen twenties, and the stock market crash of 1929 may have helped restore investor confidence. Whether such a requirement imposed on a permanent basis creates a better-informed market is less obvious.

In the pre-1933 regime, directors and managers of each firm decided whether to undertake an independent audit with its attendant costs, effort, and the potential modification of the financial reports, even with the possibility of embarrassment if the auditors discovered errors of malfeasance. They had to weigh these negatives to the firm and to themselves against the potential benefits of convincing its shareholders, lenders and tax collectors of the reliability of the financial reports. When these benefits exceeded the costs, the firm would find it in its own best interest to undertake the independent audit. If the cost or risk of the audit was not worth the benefits of higher investor confidence, they would have dispensed with the audit unless it was demanded by some other regulatory process such as rate-setting for utilities.

This cross-sectional variation in whether or not a firm subjects itself to an independent audit is valuable information to the investors. All things being equal, the investors can logically conclude that the firms that choose to have their financial reports audited by independent auditors have nothing to hide from the investors; that the managers of such firms are relatively more confident about the status, performance and prospects of their business; and that they deserve the trust of the investors. On the other hand, the investors may logically conclude that the firms which choose not to have their financial reports audited by independent auditors, even though they could have done so, are less deserving of the investors’ trust and funds.
Making independent audit a statutory requirement shuts the door on the ability of better managers to distinguish themselves from their less competent brethren in the eyes of investors. The decision to engage an outside auditor is a costly signal that only the better managers will find worth paying for. For the less competent managers, the cost of the independent audit is not worth the benefits; their fear of exposure would keep them from subjecting themselves to an independent audit. In the pre-1933 era the better-run firms could signal their status to the investors by engaging outside auditors; the other firms could not afford to issue such false signals because they were costly. The statutory requirement to have all publicly held firms engage such auditors eliminated the signal, and in this sense, reduced the amount of information available to the investors about the firms and their managers. The economic consequences of a well-intentioned change in the law can be at surprising variance with the legislative intent.

Independence of Auditors

The independence of auditors has been the subject of extensive comment and analysis. Recent debates have focused on the infringement of independence by fees for consulting services rendered by the firms to their audit clients. Charges of such infringement are credible, despite the vehement denials by the audit industry. In the U.S., the audit industry temporarily scaled back on marketing of consulting services to its audit clients in the wake of Sarbanes-Oxley legislation.

However, the independence problem is deeper than consulting. If the consulting revenues encroach upon the independence of the auditors, so must the revenues from the audit services. If the auditors’ judgments are likely to be influenced in the direction favorable to the management by the prospect of gaining consulting services, gaining or retaining the sale of audit services
should also be expected to have a similar effect on their judgments. Under the current system, managers whose representations are the subject of the audit, are also the paymasters of the auditors.

As mentioned earlier, an early draft of the Securities Exchange Act named the GAO to conduct the audit of publicly held firms. A government monopoly on a statutory audit presents difficult managerial problems of promoting efficiency and improving the technology of auditing. Variations on this theme could include an audit by organizations controlled by stock exchanges in which the securities of the firm are listed, or states in which the firm is incorporated.²⁷ Such audits could remain mandatory, and become a part of the package of regulatory services on which the stock exchanges or the states compete with one another. Alternatively, the exchanges or the states could let the firms choose if they wish to be listed as an audited or as an unaudited corporation, and make their choice of audit status known to investors. The ability of firms to choose among the exchanges or the states, and between the audited and unaudited status will minimize the chances that their regulatory auditors will extract large rents from them; or that such auditors will be grossly inefficient, as might be the case with a single nationwide auditor controlled by the government.

Competition Versus Independence

Although the debate on auditing has been focused largely on auditor independence, such was not always the case. In the 1970s, the U.S. Congress subjected the audit industry to intense scrutiny, not for independence, but for insufficient competition (see the U.S. Congress reports of

²⁷ Unlike most countries of the world, the US allows corporations to be incorporated under the laws of any of the fifty states. This system of “competitive federalism” is referred to elsewhere in this note. See Romano (2002).
the Moss and the Metcalf committees). Competition and independence of auditing are closely linked to each other in a complex relationship. Policies based on the insufficient appreciation of these links bear at least a part of the blame for the loss of both competition as well as independence in the audit industry. Consider two ways of thinking about the link between independence and competition.

At one level, there is an almost mechanical linkage between audit independence and competition. At one extreme, we could have a single, very large, audit firm for the entire economy. This monopoly auditor would have enough resources to audit all firms. No single client would account for a sufficiently large proportion of its revenue. This auditor would be maximally independent, but the market for audit services would have no competition, generating potential inefficiencies associated with monopolies. At the other extreme, we could have a large number of small auditors. In such a maximally competitive market, independence will become scarce. Each auditor will be largely dependent on its small number of clients for his livelihood, and be economically susceptible to client pressure. There are other possibilities between these two extremes. As we move from one end of the spectrum towards the other, we can gain more competition by sacrificing some independence, or gain more independence by sacrificing some competition. We cannot attain more of both.

Pursuit of Competition

Paradoxically, after a quarter-century long pursuit of competition by policy makers, the U.S. audit industry has been reduced to only four major competitors. How did this come about? This takes us to the second level of analysis.
While the antitrust laws to promote competition in trade and industry have been on the books in the U.S. since the late nineteenth century, these laws were not enforced on “learned professionals” such as doctors, lawyers and accountants. In their codes of ethics, the professional associations included provisions to proscribe advertising and solicitation of competitors’ clients and employees as being unprofessional. The economic rationale for this informal exemption for the professions lay in the asymmetry of information. It is difficult for the clients of the professionals to see the quality of services rendered to them. Indeed, they often rely on the professionals to advise them on what services they should buy. Emphasizing competition in this setting, it was feared, would result in lowering not only the price but also the quality of the professional services. George Ackerlof, formalized this idea in his model of the “Market for ‘Lemons’” for which he received the Nobel Memorial Prize in Economics in 2001.

About the time Ackerlof’s argument was published in 1970, questions were already being raised about its validity for the markets for professional services. Stigler argued that competition was a robust phenomenon, and that the reputation of the quality of goods or services provided served as an effective antidote for the problems caused by information asymmetries. When sellers can develop reputations with the customers, we need not fear that the competition will lower the quality of goods or services they sell.

The U.S. Supreme Court, which had heretofore sustained the ban on advertising in the market for professional services, ruled in 1977 that the Bar of the State of Arizona could not prevent its members from advertising their services. Though the case was decided on the grounds of (commercial) free speech guaranteed by the First Amendment to the U.S. Constitution, arguments about the opportunity to build reputations played an important role in
this ruling. Though not directed at them, it turned out to be a watershed ruling for the auditing profession in U.S.

The Supreme Court ruling led the U.S. government to change its policy on professional competition, and the latter forced the professional associations to drop the anticompetitive provisions from their codes of ethics. The American Institute of CPAs changed its Code of Ethics effective 1979, resulting in major, largely unanticipated, consequences.

Generalization of the reputation argument from the professions of medicine, dentistry, and law to auditing was fundamentally flawed because the results of the medical and legal services are observable, at least ex post, to the customers in a relatively prompt manner. Such observations have a reasonable, albeit imperfect, correlation with the quality of services rendered, reputation can keep these markets from collapsing under competition. This is not the case with the market for audit services.

Corporate managers and directors hire the auditors. The real clients of the auditors—the investors—never see the auditors. Even if they did, they could not tell if the auditors have done their job diligently. Managers who see the auditors hardly have an incentives to check on auditor diligence in checking managerial representations to investors and others. Only on rare occasions, when a corporation runs into serious financial trouble, questions may be raised about the fairness of its financial reports and the quality of the audit work behind their certification. More than 99 percent of the time, no questions are raised about the quality of the audit, and no one looks into what the auditors actually did. In this environment, there is hardly any opportunity for the auditors to build their reputation based on the quality of their work. Thus the reputation argument cannot be generalized from other professions to the auditing profession.
Yet it was, and under the pressure of competition, auditing turned into a “market for lemons.” The prices dropped as the corporate controllers solicited new bids from audit firms, year after year, to get a better price from their auditors. At these ever-lower prices, the auditors could not continue to do what they had long done and still earn a decent living. Something had to change, and it did. To survive in this new competitive environment forced upon them, auditors built themselves a new business model. It had three new elements—a new product mix, a new production function, and a new compensation policy.

A New Business Model for Audit Firms

A certain amount of business advisory services or consulting had always been part of the product mix the auditors offered their clients. The auditors could make money by selling more consulting services to their audit clients because they already had a close business relationship with the top echelons of management, and detailed knowledge of the operations, the financial status, strengths and weaknesses of the business. An established relationship of mutual trust made it easier for management to give the task to the consulting colleagues of the auditor, instead of searching for competent consultants elsewhere. Management saved the search costs, and the consultants working inside the audit firm saved a large part of their marketing costs. The auditors decided to exploit this cost advantage to sustain the money losing audit operations.

The failures of auditing have often been blamed on these consulting services. Admittedly, the rapid expansion of consulting services peddled to the audit clients could not have had a salutary effect on the diligence with which they examined the fairness of the financial reports. However, the expansion of the consulting services to become the tail that wagged the dog of
auditing business came about as a consequence of the collapse of the audit market: as the government pushed competition on the audit business, and the audit prices and profitability collapsed, the auditors turned to consulting as a recourse. The expansion of consulting was a consequence—not the cause—of the collapse of the audit market. Unfortunately, most solutions, including the SOX legislation that purportedly deals with the collapse of auditing have misdiagnosed the symptom of consulting to be the cause and is unlikely to be effective.

The second element of the business model was a new production function for auditing. Audit work consists of two main elements—analytical review and substantive testing. Analytical review is a structural, temporal and cross-sectional comparative evaluation of the financial report to assess its overall soundness. Once the auditor has invested the effort to model the firm and its environment, analytical review becomes essentially an armchair exercise. Substantive testing is the direct verification of the resources and obligations of the firm in the field, and requires costly checking of physical plant, inventories, creditors and debtors of the firm. Although the auditors developed sophisticated statistical techniques to design efficient sampling methods to cut these costs during the third quarter of the twentieth century, substantive testing consumed the bulk of the auditing budgets. Under the pressure of competition, the auditors shifted their production function from expensive substantive testing towards inexpensive analytical reviews. A greater part of the audit work could now be carried out without leaving the office, with less time, labor, and costs.

The third element of the new business model was to lower the compensation of the new entrants to the audit profession. This was reflected almost immediately in the drop in the number
of college students choosing to major in accounting, and a few years later, in the number who chose to take the examination for entry into the CPA profession (reference and chart??). Auditors might have hoped that this new business model would sustain the economic viability of their firms. But it could not, because the shift in the business model had important consequences the model had not accounted for. The cut backs in substantive testing—the auditors visiting the warehouse shelves to count inventories and requesting direct confirmations from those who were supposed to owe money to their clients—meant more opportunities for willing managers to misrepresent their numbers, with lower chance of being discovered. Increased emphasis on selling high margin consulting services to their audit clients forced even haughty audit partners to become pleading salesmen at the clients’ door. Such partners were hardly in a position to stick to their judgments about the fairness of the financial reports in high stakes negotiations with the chief executive and financial officers of the firms; the latter could always throw another consulting project their way, and hint at finding another auditor. The drop in audit prices forced a change in the production function and the product mix, which in turn cut into the quality of audit services. But the auditors’ liability had not been reduced. The consequences followed none too soon.

Liabilities Eat the Profits

By the mid-eighties auditors saw a sharp rise in the number of lawsuits against them, alleging negligence in auditing. The suits worked their way through the in- or out-of-court settlements, including some cases where auditors paid over a hundred million dollars in damages for a single audit. The new business model did not yield the hoped for profits, and the auditors had to revise
it again. They reinforced all three elements mentioned above, and added a fourth. Consulting services had already become the mainstay of audit firm profitability. They shifted their college recruiting to people who could work on consulting, not auditing projects. Abandoning their long-held policy of pushing the universities to offer courses in advanced accounting skills that could be employed in audit tasks, the major accounting firms financed the Accounting Education Change Commission for the American Accounting Association, urging the universities to train strategic thinkers (read consultants), instead of accountants. They continued to move the audit production function away from substantive tests to analytical models to reduce the labor costs of audit. The profession was determined to follow its new business model to deal with the consequences of the competition that had been forced upon it. The auditors’ liability had become a thorn in their side and an obstacle in their pursuit of this model. They turned their attention to finding a remedy for this problem.

When the courts found that the audited financial reports did not fairly represent the financial status and performance of the firm, the auditors were held jointly and severally liable, along with managers, directors, etc., and asked to pay damages to the plaintiffs. Far too often in such cases, the other parties held liable had little resources, and the auditors ended up paying the share of damages attributable to themselves as well as to the others. The auditors identified this joint-and-several liability doctrine as the main source of their problems, and determined to replace it by proportional liability which would allow them to pay only their own share of the damages. How was this change to be accomplished?
A Political Strategy

Physicians and lawyers had financed elections for many years, and benefited handsomely from the political payoffs from their benefactors. Accountants, too, decided to follow the suit, and began to organize and raise money to finance elections in order to gain access to legislators. They progressively ramped up financial contributions to the elections in 1988, 1990, 1992, and 1994 and lobbying efforts in Washington and the state legislatures. In 1995, Congress finally passed the Private Securities Litigation Reform Act, switching the auditors’ liability from joint and several to proportional. As a sweetener to the business lobby from the high-tech U.S. industry, this Act also permitted publicly-held companies to include forward looking statements in their financial reports under a safe harbor provision. As long as such statements were clearly labeled to be forward looking, the management could not be held liable for errors in such statements. It was a measure of the lobbying power of the accountants that this was the only Act passed by Congress overturning a veto during the eight years of Clinton presidency.

The 1995 Act cleared the way for the new business model of audit firms to take effect. They no longer wished to be called auditors or accountants. The new production function did not do much auditing any way. A new term—assurance services—was coined to describe what used to be the audit part of their business. With the revenues from consulting they thought they could pay whatever proportional liability from the assurance services came their way from the courts. It has been alleged that, at Arthur Andersen & Company, the authority to make the final calls on matters of accounting principles was transferred from their legendary and tough central office group in Chicago to the engagement partners directly responsible for the audit in the field. The
pressures on audit partners to fulfill their quota of consulting revenues from their audit clients rose to a level that forced many old-timers to quit by taking early retirement. The rush for making money in the go-go days of dotcom bubble was on, and the auditors became the perpetrators, the short-term beneficiaries, and ultimately the victims of the bubble.

SEC Fumbles Diagnosis

The SEC saw the trouble, tried to stop this race, but like many others, misdiagnosed the consulting revenues of the audit firms as the source of the problem. It did not see that the growth of consulting for audit clients was a consequence of the competition that had been pushed on auditing through the change in government policy in the late seventies. In any case, the accountants used their political muscle to partially beat back the SEC proposal to prohibit the audit firms from providing consulting services to their audit clients, and settled for public disclosure of the consulting fees.

All major economic and stock market downturns leave behind the detritus of collapsed businesses and dashed hopes, including some accounting and auditing scandals. The events of 2002 were different only in the unusually large number of accounting and auditing related surprises, and their large magnitude, often running into billions of dollars. It did not help that in pushing competition on all professions in the late seventies, the government policy failed to consider the special susceptibility of the market for audit services to become a “market for lemons.” In pushing for competition, the government not only damaged auditor independence, but competition too. After a quarter-century of efforts to promote competition, the number of large audit firms who audit most publicly held firms was halved to four.
Time for Rethinking

This overview of the U.S. events calls for a review of the institutions of accounting and auditing, which are mostly taken for granted. We review the possible ways forward in Chapter 7.

References


7: Ways Forward

A great deal of accounting scholarship has addressed micro-level details of relationships among rules, reports, disclosures, and individual decisions and market behavior. This work has yielded many insights into financial reporting viewed as a source of information for decision making. Putting social norms on the back burner, accounting institutions have been created to serve this purported goal by writing extensive standards of financial reporting and auditing.

Stepping back to take a broader perspective on the evolution of accounting and auditing over the past century raises a different question: Is financial reporting better now than in the past? It is difficult enough to answer this question, and we refrain from addressing an even more challenging hypothetical question: Would financial reporting have been better had the actions of the past decades not been taken?

Chapter 2 points out that “better reporting” is not meaningful if we look at the world through Panglossian glasses of positive theory; accounting, like a church wedding ceremony and other rituals of life, simply is what it is. Research on better reporting is no more fruitful than research on better weddings. One might wonder why so much research is being done on financial reporting where positive theory has become the dominant paradigm. Perhaps research too, viewed through Panglossian glasses, simply is, not subject to value judgments about its purpose, direction or quality.

As a matter of personal taste, I think of financial reporting not simply as a social phenomenon but also as a human artifact engineered to serve human purposes. Chapter 2
explored attributes and objectives approaches to seek guidance for our actions. The appeal of both is unfortunately accompanied by their logical impracticality in yielding reporting choices; multiple desirable attributes of financial reporting are largely incommensurate, and multiple goals of society and of various groups are irreconcilable at all but the most general, almost philosophical, levels. The analytical approach to progress towards better financial reporting is consequently blocked.

Chapters 4, 5, and 6 explore rules, social norms, and institutions. The appeal of written rules—concrete, salient, published, easily disseminated, cataloged, and specified with precision, subject to analysis and discussion, formulated by known transparent and often democratic processes, subjected to comments and amendments and enforcement by socially-accepted processes, is obvious. Written rules appeal to our sense of good housekeeping. Social norms, on the other hand, are messy, vaguely defined, variable in time and space, calling for extended socialization to learn and internalize, with a penumbra of uncertainty, evolved slowly by poorly understood processes, difficult to direct at identifiable problems of the day, are almost impossible to defend when scandals hit the news cycle, and mock our expertise, efficiency, and expertise. Politicians find it so much easier to pacify the public by turning to their legislative powers and writing new rules to ban the business practices, devising administrative mechanisms for their enforcement, discrediting the prevailing norms, claim victory, and move on. Yet, the problems reappear soon.

It is my hope that some configuration of rules, norms and institutions may help us find a way out. We do need written rules; the cost and time needed to coordinate, resolve conflicts, and maintain order by mutual understandings and expectations alone, beyond small family groups,
are unbearably large. Code of Hammurabi spelled out 282 laws for everyone in the kingdom for this purpose some four millenniums ago.

But what can be written down is necessarily incomplete, and not just because it is not possible to write rules for every known contingency. The relationship between additional written detail and their effectiveness in achieving the intended consequences is unclear. Loopholes are unshakable shadows of every rule; attempts to close the loopholes by adding detail only opens new ones. Social life is rendered possible only by the system of less formal shared mutual expectations of behavior and largely internalized sanctions we call social and cultural norms. Rules and norms work in tandem like the stereotypical father’s discipline and mother’s softer warmth to raise a healthy and happy child.

The adoption of International Financial Reporting Standards (IFRS) in the European Union and some other countries was promoted by aspirational rhetoric about gains from uniformity. Since outcomes are determined jointly by the rules, and the environment to which they are applied, application of the same process or rule to diverse societies does not yield comparable outcomes. We need to assess not only if the vision of one set of global accounting standards is achievable but also if it is desirable.

Practice of financial reporting interacts in complex ways with the prevailing law, commercial code, economic environment, and business practices. Complexity and interactivity of social systems and markets make it difficult for a group of experts to devise accounting solutions to better serve even a single, much less diverse, economies. Even if it were feasible, it can only be developed through bottom-up evolution of accounting and not through top-down imposition of a single method selected by a board of “experts” with limited accountability.
There are no recipes for effectively combining the rules and norms. Perhaps our hope lies in building and supporting institutions to attain an acceptable balance between the two. Since human intelligence has not proved to be proficient in designing social systems top-down, a good dose of modesty in proposing such institutions is called for. What might such institutions look like? Let me conclude with a rough outline.

The institutions of accounting should have a broad representation from the relevant constituencies, and not be dominated by narrow interest groups. Such institutions will take into account the consequences of their actions for various parts of society.

These institutions should try to develop a consensus, and not act by a mere majority vote. It will allow some parties to block issuance of rules when they are not yet ready to be accepted broadly by the business and accounting community. This will also mean that such institutions will not be biased towards action, nor will they be assessed by the rate at which they issue new pronouncements. It is entirely possible that such organizations may issue fewer pronouncements, and may not issue any pronouncements during significant intervals of time. When that happens, it will be an indication of their care in carrying the community along, and not of incompetence.

Such institutions of accounting will rely on their soft power of reason, explanation, education, disclosure of practices, and development of consensus, instead of the stick of regulatory enforcement. Their power to persuade will be more like that of the Oxford English Dictionary, allowing for slow evolution of meaning of words, adding new words from current usage, but also serving as a book of reference and an informal disciplinary and dispute resolution mechanism. Such institutions do not shy away from diversity. On the contrary, diversity of
practice serves as the feedstock of innovation, deliberation, comparative research, learning, and new ideas.

Before proposing untried new ideas for adoption in practice, such institutions will conduct field tests of their own. They can do so by encouraging some organizations to implement the proposals on a trial basis in their financial reports, as well as by beta testing them with general public, especially the students, to find the weaknesses in the proposals.

The institutional structure will be more resilient, especially in a world of financial engineering, if it resists the temptations of monopoly. To the extent a handful of institutions are permitted to compete for allegiance of the same reporting entities and their constituents, under general supervision of regulators, they will compare, learn, innovate, and balance various interests more effectively. It will also be easier for competing institutions to resist the pressures to write increasingly detailed rules (Sunder 2011b). It would be possible, for example, for a competing audit regime to operate without mandatory audit, and for a financial reporting regime to require full conformity with tax reporting. Whether any entities choose to operate under such regimes without being abandoned by their constituents cannot be known until the doors of competition are opened.

Such “soft” institutions will be back-stopped by newly created accounting courts to decide on, and develop the case law of financial reporting. These courts will judge the cases before them by common law criteria such as “true and fair” representation, and not by conformity to any published rules alone.

Even robust institutions break down under sufficient pressure. Self-interest of constituents is the source of such pressures on financial reporting. During the recent decades great deal of such
pressures on financial reporting arose from performance-contingent executive compensation. When millions or hundreds of millions of dollars of executive compensation is tied income and sales in financial reports, maintaining the integrity of the reports becomes very difficult. U.S. regulators have not helped by their mixed record in this respect. On one hand, they have tried to reign in excessive compensation of senior executives by highlighting the ratio of senior executive and median employee compensation (McGrane and Lublin 2015). On the other hand, they have asked public companies to link executive compensation to measured financial performance (SEC 2015). Promoting such linkage will only increase the pressure on financial reports and softer approach to institutions of accounting.

We cannot be sure if these suggestions will result in better financial reporting. However, given how little progress we have made during the past eight decades, it may not hurt to try these ideas, or at least engage in active debate on alternatives to the status quo.

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