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Adverse effects of uniform written reporting standards on accounting practice, education, and research [☆]

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ABSTRACT

When transactions have multiple attributes, achieving uniformity in their classification depends on whether similarities or dissimilarities are of interest; uniformity with respect to both is not possible. The pursuit of uniform written standards at the expense of social norms diminishes the effectiveness of financial reporting in stewardship and governance, and in keeping the security markets informed. A shift to written standards discourages thoughtful classroom discourse on alternatives which develop professional judgment. It also engenders “by the book” attitudes and drives talent away from accounting programs and, ultimately, from the accounting profession. Judgment and personal responsibility being the hallmarks of a learned profession, the dominance of uniform written standards weakens the claim that accounting programs belong in universities alongside architecture, dentistry, engineering, law, and medicine. Uniformity discourages research and debate in academic and practice forums and promotes increasingly detailed rule-making. It shuts the door on learning through experimentation, making it difficult to discover better ways of financial reporting through practice and comparison of alternatives. Improved financial reporting calls for a careful balance between written standards and unwritten social norms.

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Samuel Johnson published his dictionary (Johnson, 1755) 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 Breen (1992), Former Chairman, SEC

The pursuit of uniformity in accounting practice through written standards and their enforcement by authority has been a prominent theme in financial reporting during the past half-century. In the current decade, the convergence of accounting standards and the harmonization of accounting practice have been the policy of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). If the current trends continue, the US, the EU, and many other parts of the world may claim to have reached this long-sought goal of uniformity in the foreseeable future.

The pursuit of uniform financial reporting through the official enforcement of standards written by organized boards enjoys broad support from government, business, the accounting profession, and academia. For evidence of this broad support, we can look at (1) practice: all four major firms have significant campaigns to promote IFRS for the sake of uniformity, (2) textbooks: the space given to written standards of financial reporting, (3) research: the number of papers in our journals concerning written standards, and (4) professional meetings: the number of sessions in the AAA's professional meetings – the Anaheim meeting in 2008 had more than a dozen sessions on written standards. Further, noteworthy by its rarity in our discourse is mention of the role of social norms in accounting. The label of “generally accepted” in accounting and auditing is now claimed for “what is required at the threat of penalties.” It is widely believed that uniform written standards will result in improved financial reporting; better governance and stewardship of business, not-for-profit, and governmental organizations; and better informed and more efficient financial markets directing capital toward productive deployment. When accounting problems arise, we look to written standards to address them.

This paper presents a contrarian case: when transactions have multiple attributes whose similarities as well as dissimilarities are of interest, a uniform scheme of classification is not feasible. The pursuit of uniform written standards at the expense of social norms diminishes the effectiveness of financial reporting in stewardship and governance, and in keeping the security markets informed. Before the enactment of federal securities laws in the 1930s, social norms played an important role in accounting which has gradually diminished during recent decades. Accounting has dispensed with its equivalent of common law, discouraging thoughtful classroom discourse on alternatives that would help develop professional judgment, and inducing “by the book” attitudes that drive talent away from accounting programs and, ultimately, from the accounting profession. Judgment and personal responsibility being the hallmarks of a learned profession, the dominance of uniform written standards weakens the claim that accounting degree programs belong in universities alongside architecture, dentistry, engineering, law, and medicine. Uniformity discourages research and debate in academic and practice forums, and promotes increasingly detailed rule-making. It shuts the door on learning through experimentation, making it difficult to discover better ways of financial reporting through practice and the comparison of alternatives. Better financial reporting calls for a careful balance between written standards and unwritten social norms. Allowing several standard-setting bodies to compete, under regulatory supervision, for royalties from those who follow their standards may help achieve such a balance.

The enthusiasm for the pursuit for uniformity to the exclusion of social norms should be tempered by the recognition of unintended consequences arising from the path regulators of financial reporting

have chosen. Perhaps it is not too late to adjust our goals so we can improve financial reporting by seeking to balance written standards with the unwritten social norms of the accounting and business community. I address the nature of uniformity and the role of social norms, institutions, and law in accounting theory, practice, education, and research before turning to reforms that might help pave the way for better financial reporting.

1. Uniformity and classification

Uniformity has long been the holy grail of rule-making in accounting.¹ Diversity in accounting practices invites criticism rooted in an intuitively appealing idea that if the accountants would treat similar transactions similarly, and different ones differently, financial statements would be more useful. Unfortunately, this is not true. The problem is that two events or transactions are rarely exactly identical or totally different. Close examination nearly always reveals some similarities as well as some differences between any pair.

Transactions come in limitless variety, and the accountant must classify and aggregate them into a manageably small number of categories. We can use one of the following two principles to classify any set of transactions into a smaller set of categories:

- (1) Treat any two transactions that have any differences differently.
- (2) Treat any two transactions that have any similarities similarly.

Superficially, the two criteria may appear to be the same, but they yield quite different results. By choosing one, one necessarily violates the other, giving rise to a fundamental difficulty in defining and attaining uniformity and comparability in accounting (Sunder, 1983, 1997, pp. 143–144).

In applying the first criterion, each transaction, being different from all others in *some* respect, must be treated differently. This yields an unmanageably thick accounting rule book, with each rule being used for only one transaction. In effect, there is no categorization and no aggregation. Some may call this a system without rules or uniformity because no two transactions are treated alike. Others can, with equal justification, refer to the system as the ultimate in uniformity in the sense that two transactions must be exactly identical in all respects in order to qualify for the same treatment. In a world where transactions have multiple attributes of substantive interest, pursuit of uniformity carried far enough leads to complete diversity.

Paradoxically, applying the second criterion does not help. If every pair of transactions that have anything in common between them are treated alike, then all transactions are covered by a few categories, or even a single one. In accounting, this is not of much use. This problem is common to all systems of rules and laws, as well as to other schemes of classification.

The point can be graphically illustrated by a simple example of four objects which differ in, say, size and color – two large, two small, two black and two white (see Panel A of Fig. 1). Applying the first uniformity criterion to size (objects with any differences should be treated differently) we get the classification shown in Panel B. However, this classification would leave dissatisfied those who consider color to be the important criterion. Applying the first uniformity criterion to color, we get the classi-

¹ *Uniformity* “overall sameness, homogeneity, or regularity” (Random House Dictionary); “freedom from variation or difference, ... consistency, sameness” (Webster’s Revised Unabridged Dictionary); “a condition in which everything is regular and unvarying” WordNet 3.0; “adherence to an imposed regulation or established rule or custom” (Kohler’s Dictionary for Accountants, 1983). Further, Kohler’s Dictionary has an entry that anticipates the difficulties of attaining uniformity: *uniform accounting system A* system of accounts common to similar organizations, such as those developed or promoted by associations and those promulgated by federal and state regulatory bodies such as public utility commissions. Attempts to establish uniform accounting for an industry or for all forms of human endeavor have been unsuccessful, at least in the United States, because the principal objective has been the development of elaborate, categorical classifications of accounts designed to aid in making comparisons, or to facilitate the construction of macro statistics, whereas the aim in micro accounting has been to provide information peculiar to the self-contained, self-concerned organization or individual; information not readily adaptable, without substantial adjustment, to a macro buildup. In the so-called “Norwalk Agreement” the FASB and the IASB committed themselves “to the development of high-quality, compatible accounting standards” without defining either “compatible” or “high-quality” (<http://72.3.243.42/news/memorandum.pdf>).

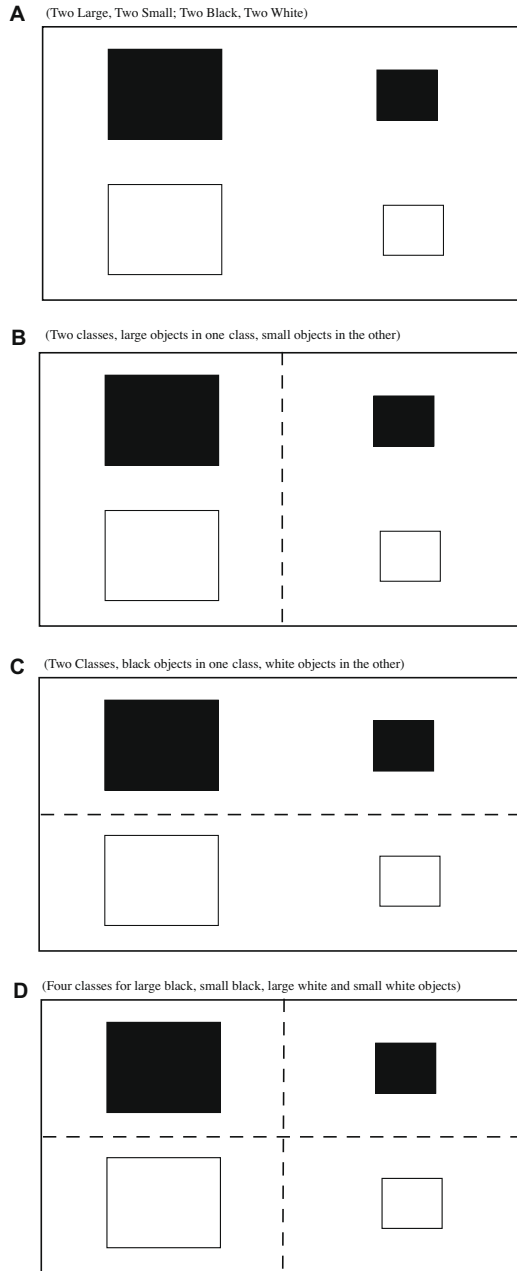


Fig. 1. Panel A: Four objects with two properties (size and color) (two large, two small; two black, two white). Panel B: Classification of four objects by size. (Two classes, large objects in one class, small objects in the other.) Panel C: Classification of four objects by color (two classes, black objects in one class, white objects in the other). Panel D: Classification of four objects by size and color (four classes for large black, small black, large white and small white objects).

fication shown in Panel C, which would leave unhappy those people who consider size important. It would seem that there is a simple solution that would make them both happy: apply the first criterion to both size and color, and we get the four-way classification shown in Panel D.

However, D is far from perfect when we look at the second criterion of treating similar transactions alike. This four-way classification leaves one to wonder why two objects which are both black are being treated differently, and why two objects which are both large are being treated differently. In short there is no conceptual way, even in a simple theoretical example, of satisfying the uniformity criterion in a world in which more than one attributes of objects, transactions, or events are important to the users of financial statements. In practice, things get even more complicated.

The accounting treatment of research and development (R&D) outlays is a case in point. Until the FASB issued FAS 2 in 1974, capitalization of these outlays was left largely to the discretion of management. Practices varied across firms. Demands for uniformity led the FASB to search for rules that would reduce management discretion in capitalization decisions and closely approximate the economic substance of these events. It soon became evident that there was no way of satisfying both of these requirements. The nature and circumstances of research and development outlays, and their results, vary so greatly that it is not feasible to lay down rules that will remove management discretion without also weakening the link between the economic consequences of R&D outlays and their accounting treatment.

The FAS 2 removed managers' discretion by requiring that these outlays be expensed. It achieved uniformity of form, not substance. The underlying event that is supposed to be recorded is not the R&D expenditure alone, but also its economic consequences. Expensing all R&D outlays, irrespective of the results, creates a greater divergence between the underlying event and its accounting treatment than might occur under a discretionary system. Two firms, each having spent \$10 million on research, will have identical financial statements, irrespective of the development of a hot-selling product by one of the firms. Whether FAS 2 has led to greater uniformity of financial statements in this fundamental sense is questionable.

To summarize the first main point, there is no conceptual way of defining the uniformity criterion that can help guide standard setters, preparers or auditors in improving financial reporting. Concepts such as uniformity, comparability, and compatibility, often used interchangeably, are operationally vacuous for accountants' work.²

2. Written standards versus social norms

Norms of a social group can be defined as the common-knowledge expectations of its members about how they and their fellows should behave in various circumstances.³ Wearing a coat and tie in an office is its social norm if, even in the absence of any formal rules and enforcement processes, and in the presence of available and convenient alternatives, men do in fact wear coats and ties and expect others to do the same. In this sense, social norms or conventions are indistinguishable from the culture of the group (Sunder, 2002c, 2005a,b).

Unlike formal rules and regulations, motivation to conform to social norms is rooted in the anticipation, or even fear, of embarrassment and others' disapproval of deviations from the norms. Social norms may be so internalized by individuals that conformity may be seen as a moral or ethical obligation. When norms become sufficiently internalized, the members of the group may find it redundant to monitor conformity, giving rise to trust. The key mechanisms that create trust in society are personal relationships and the social embeddedness of market participants rather than the legal rules and the formal enforcement structures.⁴

It has been a long time since accountants began to shift their allegiance and attention away from norms. Today the authoritative promulgation of accounting standards is often assumed to be

² "[T]... the Boards (FASB and IASB) reaffirmed their commitment to the goal of convergence. In doing so, however, they again rejected the dictionary definition of convergence, moving toward union or uniformity, as an end in itself, agreeing instead to focus on convergence as described in the 2002 Norwalk Agreement – the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting" FASAC (2005).

³ Common knowledge of X, in its technical meaning, is shared knowledge among two or more people such that each knows X, knows that others know X, knows that everyone knows that everyone else knows X, ad infinitum.

⁴ See Cook (2001) on the role of trust in society.

synonymous with progress. It is easy to identify the history of accounting principles with organized efforts to produce written rules, because documentary traces of such processes are readily available to the historians. On the other hand, even widely accepted social norms leave nary a footprint in the public record. We can see the evidence of norms in fiction.^{5,6} Unfortunately, accounting is hardly a favorite subject in English literature, or in the literature of any other language, for that matter.

The early predominance of norms is clear from 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 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, 1971, p. 112).

In 1918, a reprint of a memorandum on auditing procedures, prepared by the American Institute of Accountants, approved by the Federal Trade Commission (FTC), and originally published in the Federal Reserve Bulletin, was labeled “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 behind this effort was to coordinate the evolution of accounting norms 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 recommended against the inclusion of imputed interest in the cost of production, and this recommendation was approved at the annual meeting of the Institute. Nonetheless, the recommendation failed to win acceptance as an accounting norm.

The absence of authoritative standards of accounting did not mean that the world of accounting had less order in the early 20th century than in the early 21st. Zeff discusses several active mechanisms that the accountants of the day might have used to develop and identify the norms of their profession. Pages of the Journal of Accountancy and the 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 gradually displaced the norms in discourse and practice. During 1920–1929, 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.⁷

The stock market crash of 1929, and the economic depression that followed, also precipitated a crash in the trust in norms of accounting and the formal and informal mechanisms by which these norms evolved and were sustained. The social contract was broken. Government responded to the economic crisis by introducing securities laws, creating the Securities and Exchange Commission and its regulations to replace the norms and private innovation. In the following seven decades, accounting and audit failures came to be interpreted as evidence that norms do not work. Norms were gradually shifted to the back burner, and legislated accounting standards rose to dominate accounting.

The shift is also reflected in the increasingly assertive nomenclature of the three private sector institutions created to write accounting rules, and how they labeled their pronouncements: The Committee on Accounting Procedure’s *Accounting Research Bulletins* (1939–1959), the Accounting Principles Board’s *Opinions* (1959–1973), and the FASB’s *Financial Accounting Standards* (1973 to present). The IASB’s *International Financial Reporting Standards* are the latest addition to this regulatory trend. Grady’s *Inventory of Generally Accepted Accounting Principles* (1965) and the 62 volumes (from 1946/1947 to 2008) of American Institute of CPAs’ annual survey of the financial reporting practices of some 600 organizations under the title *Accounting Trends and Techniques* are examples of the attempts to support the evolution of social norms of accounting. Has the increased assertiveness of written rules,

⁵ For examples of accounting and commerce in Chaucer and Goethe and other German literature, see Russell (1986), Gallhofer and Haslan (1991), Jackson (1992), Ganim (1996), Maltby (1997), Parker (1999); Evans (2009).

⁶ 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.

⁷ In his review of *Costing Terminology*, Kitchen (1954) provides a masterful argument for resisting the temptation to issue official definitions, especially in accounting. See also Baxter (1953).

and the confidence they imply in the ability of corporate entities such as standards boards to devise better methods of accounting been justified by their actions?

2.1. Accounting institutions

Written standards with formal enforcement are concrete and salient. Standards are published, easily disseminated, specified formally with some precision, and can be cited, analyzed and discussed chapter and verse. They come into existence at a specific time, through a known and well-understood institutional process that may allow the constituents to participate. 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.⁸ 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 extended socialization to learn and understand them.⁹ 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 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, make a mockery of 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 displace markets and social processes and write new standards instead of relying on existing (recently discredited) norms and business practices.

There is also a fundamental weakness in the structure of a standard-setting body. A permanent rule-making bureaucracy must produce rules in order to justify its budget and existence. If the making of rules is their only responsibility, should we not expect them to write new rules and, inevitably and routinely, add to the thickness of the rulebook with the passage of time? Until its public financing by the provisions of Sarbanes–Oxley Act of 2002, the FASB was dependent on the sale of its publications for a significant part of its revenue. The rule of “publish or perish” is as true for rule makers as it is in academia.

Another consequence of having institutions with rule-making as their sole function is that their very existence invites and encourages requests for clarifications. Clients ask their auditors to produce a rule to back up their judgment calls, especially when their judgment is to a client’s disadvantage. If the FASB/IASB does not respond to a call for rule clarification in a timely fashion, it can become the basis for allowing a client to have his way. Absent the rule-making agency, auditors would have to worry about the fair representation requirement under the security laws. The existence of standards boards promotes an attitude of, “if it is not prohibited, it must be permitted.” Investment bankers frequently play a game of hide-and-seek: they call the FASB/IASB for rule clarification and then do some financial engineering to get around the rules. While a reasonable body of rules might be devised to deal with a given set of transactions, it is impossible to devise a system of rules when transactions are continually redesigned to get around the rules and to frustrate the intent behind them.

⁸ In response to 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 US accounting profession and, as indicated in the opening quote, generally seemed to favor norms over standards.

⁹ See Fuller (1964) and Dworkin (1986) for a discussion of natural law theory, Hechter and Opp (2001) for an overview of the sociology of norms, and Coleman (1990) on social conventions.

3. Law and social norms

Legal scholarship and practice carefully recognize 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 reasonable doubt, jurors want to know how much doubt is reasonable: ten, two, or one percent? The law does not attempt to codify answers to such questions. Legislators and lawyers understand all too well the consequences of clarifying such questions can be even less desirable than the consequences of leaving them to judgment, even when the judgment is exercised by lay people. Similarly, the US Securities and Exchange Commission (SEC) and Congress refuse to clarify the definition of insider trading beyond “trading on non-public information.” The consequences of writing clarifying rules to specify what constitutes non-public information are even less desirable than the consequences of leaving such matters to the ex-post judgment of investors and the enforcement and judicial systems.

Accountants, on the other hand, have been willing to pursue uniformity through endless clarification of written accounting rules, to the point of defining the percentage thresholds for materiality, lease capitalization, consolidation of subsidiaries and special purpose entities, etc. With such written standards in place it is child’s play for the Wall Street bankers, accountants and lawyers to design transactions and financial instruments to frustrate the intent of the standards, no matter how carefully they have been drafted. Setting up accounting institutions whose sole function is to issue new accounting rules, contributes to the tendency to write standards which are “generally accepted” only in the sense of “follow them, or else.” Accounting could borrow some wisdom from law, remove the monopoly jurisdictions of rule-makers, and introduce elements of regulated competition (discussed in Section 6) among rule makers within each financial reporting jurisdiction in order to avoid this problem (Dye and Sunder, 2001; Sunder, 2002a,b, 2009).

4. Practice

In practice, there are five reasons as to why attempts to create a uniform set of top-down, written standards do not necessarily dominate social norms in financial reporting. I discuss them as information, design, gaming, signaling, and clarification problems.

4.1. The information problem

Rule makers face a difficult problem in identifying better rules. One can appreciate this challenge by asking a simple question: what is a good rule for determining pass interference in a game of American football? Rules can affect different members of society (and players in a game) in diverse ways. The direct effect of the rules on people depends on their individual circumstances, of which the rule maker can have only limited knowledge at best (see Hayek, 1945). Rules are designed in the hope that they will change or constrain the behavior of at least some people; however, changes in individual behavior interact in complex ways, generating aggregate consequences that are difficult to anticipate. The rule maker may try to ameliorate this inherent informational disadvantage by soliciting information from the parties potentially affected by its actions. Unfortunately, these parties have little incentive to report truthfully. Their strategic responses muddy the waters (see Sunder, 1997, Chapter 11; Sunder, 2003), create the gaming problem discussed below, and thus often force the rule maker to deal with unintended consequences of the rules. Since they evolve over longer intervals of time, through trial-and-error, social norms can incorporate more information than rules made by legislature, boards, and other corporate entities usually can.

4.2. The design problem

Corporate, standard-setting entities need structure, people and resources. All three requirements necessitate compromises in the design of the entity. Legislative structures emphasize representative-

ness; judicial structures emphasize impartiality, while bureaucratic structures value rules of procedure above all. It is difficult to attain representativeness, impartiality, and consistency of procedure all at once in a single institutional structure (Sunder, 1988).

Finding people to operate the rule-making system raises parallel problems. The best experts may not be representative or impartial, and they may be inclined to use their judgment instead of following pre-defined procedures. Representative bodies may lack expertise in the substance of the matter, and may not place impartiality high on their agenda, and so on. Finally, those who pay for the cost of developing uniform standards understandably seek to further their own agenda through their influence over the finances of the standard-setting entity. Such inevitable compromises distort the functioning of standard-setting bodies.

In contrast, the gradual evolution of social conventions – a mass phenomenon – is less susceptible to these weaknesses of corporate entities because such entities do not play a major role in the process.

4.3. *The gaming problem*

The difficulty posed by the information problem discussed above is compounded by the dynamic interaction between rules and the behavior that the rules are devised to influence. Each standard affects the decision environments of the relevant individuals by changing their opportunity sets and payoffs, and at least potentially alters their decisions. The rule makers, with limited information, cannot anticipate all such changes, and the rules therefore often lead to unintended consequences in the form of individual behavior and their social outcomes. For example, Tan and Jamal (2003) found that reducing discretion in accounting rules has an unintended effect of changing the “real” operating decisions of managers. Any adjustment of the rules to such outcomes sets up yet another cycle of adjustments and changes. Individuals can adjust faster than the rule makers can. It is difficult to make sure that this action–reaction sequence converges to a stable pattern of behaviors which are in mutual equilibrium, and that this equilibrium is Pareto superior to the status quo (i.e., it makes at least some people better off without making anyone worse off).

4.4. *The signaling problem*

A uniform standards approach to financial reporting favors narrowing the range of options available to the reporting entity and foregoes a valuable signaling opportunity. Many believe that narrowing the set of choices available to an accounting entity in how to report a given event or transaction promotes comparability and consistency and enhances the informativeness of financial statements. This argument ignores the signaling value of the choices made by the reporting entity. In making a choice from a given set of alternatives, the entity cannot help but reveal some information about its preferences and expectations. Managers of the entity reveal their privately held information, in part, through the financial reporting methods they choose (Dye, 1985; Levine, 1996). The use of aggressive reporting methods gives valuable information to careful readers of the financial reports about how hard-pressed the managers of the firm are. Narrowing financial reporting choices through uniform standards curtails the ability of managers to transmit information through their choice of financial reporting methods. This signaling aspect of financial reporting has received little attention in the setting of accounting standards.

Under social norms a broader range of behavior remains permissible and acceptable. The more tightly specified the school dress code, the less one can learn about individual children from their appearances in the playground; without choice and self-expression, less information is available to others. Morison (1970, p. 281) wrote:

The power of free and rational argument remains, I am old-fashioned enough to believe, the best road to the truth in human affairs. I would therefore give companies the maximum freedom to present their accounts in whatever way they thought fit, and would then require them to explain and justify the course they had taken. The auditor’s task – no light one! – would be to ensure that they did. And to see they did it fairly.

I do not suggest going so far as to give companies “the maximum freedom,” but allowing them a choice among a small set of carefully chosen competing standards would be helpful.

4.5. *The clarification problem*

Since the collapse of Enron and WorldCom in 2001, accounting discourse has been dominated by claims that (1) there is a distinction between rule-based and principles-based standards of accounting, and (2) the former is exemplified by the FASB's approach and the latter by the IASB's. The appeal of this distinction rests on the longing for the simple idea of fewer, more general standards that leave details of implementation to individual judgment, as opposed to more detailed standards that try to get into more specifics of implementation. This longing manifests itself in periodic calls for simplification of financial reporting rules from preparers, users and regulators. Unfortunately, it is rooted in an inadequate understanding of the dynamics of standardization.

The location of standards on the generality–specificity axis is driven not by the *ex ante* choice of the Boards but the supply and demand for specificity, history, and the alternatives available to various participants. Most standards, rules and regulations, in accounting and elsewhere, are born small. They grow over time, not because standard setters prefer to add the details, but because earlier versions generate requests for clarification that arise from conflicting interpretations rooted in the self-interests of those who implement the standards. Requests for clarification present standard setters with a dilemma between keeping things simple (and asking people to use their own judgment in implementation), and providing clarifications and guidance which inevitably call for more detail.

If standard setters ask for the use of judgment, they risk appearing to be unresponsive to constituents. This may undermine their legitimacy, especially if they are in the private sector. Use of judgment also promotes diversity in practice, which undermines the presumed goal of attaining uniformity and comparability through standardization. On the other hand, clarification and guidance is an endless process of growing detail.¹⁰ In spite of the best intentions of standard-writers to stick to principles, over time, their work accumulates to form ever larger volumes. Therefore, the difference between principles-based and rules-based standards is not a matter of the intent of the standard setters, but the point at which they stand in this dynamic process. IASB, being a more recent entrant in the game, is in an earlier stage of the same process than the FASB. Its recent struggles with its so-called “fair value” accounting standard is an illustration of how similar processes tend to lead us to similar outcomes, regardless of the intent of a standard-setter to stick to principles.

The information, design, gaming, signaling, and clarification problems are ever-present in setting standards; they deserve consideration when we weigh the roles of uniform standards and norms in financial reporting.

5. Education and research

While the attempts to write uniform standards of financial reporting are primarily driven by their direct and immediate impact on capital markets, they also have major educational consequences. It is possible to argue that these consequences may well be more important for welfare of society, and they certainly deserve more attention from academics. Moreover, those charged with the responsibility to develop written standards should include the educational consequences of their actions in a part of their deliberations.

The expansion of the ambit of written authoritative standards has led to fundamental changes in textbooks, course content, classroom discourse and examinations, including the professional examination for CPA certification conducted by the AICPA. In the absence of an authoritative standard for a class of transactions textbooks, class discussion, and examinations explore various possible ways in which a transaction could be accounted for and the consequences of alternative accounting treatments for various parties, and for the economy as a whole. Such discourse develops the minds of students to think fundamentally. It does not allow for black-and-white answers and it helps attract abstract thinkers to the accounting profession. The exercise of judgment is a hallmark of a profession.

¹⁰ US Sarbanes-Oxley Act of 2002 and the Public Company Accounting Oversight Board's detailed approach on corporate internal controls and governance stands in interesting contrast to the comply-or-explain approach used in the United Kingdom under the Combined Code issued by Financial Reporting Council.

With the expansion of the scope of authoritative standards, educational discourse has progressively shifted toward the rote memorization of written rules that must later be regurgitated during examinations. With the accounting standards written by the FASB/IASB being granted a monopoly status for public companies, intermediate accounting classes have moved toward focusing on a chapter and verse application of those standards, and not on critical examination of the merits of alternative accounting treatments for various classes of transactions. Instructors of accounting who try to develop the analytical powers of their students face inordinate pressures to “cover” the expanding volume of written standards. Since time is limited, what is written and definite takes priority over unwritten norms and the development of subjective judgement. Such a “memory-based” curriculum tends not to attract talented youth to a profession, nor to retain their interest for very long. Indeed, few other learned professions rely on standards to the extent that accounting does.

A second aspect of the problem is educational capacity. Under the current system, college and university courses in the US spend much time and course work teaching the specifics of accounting standards. It has been argued that competition across a multiplicity of standards would call for even more accounting courses, core requirements, faculty, classrooms and other academic resources, and tuition fees or taxes to pay for them all. Under the current system of accounting education, it is not reasonable to expect students, who have been drilled to memorize the specifics of FAS, to then read IFRS and try to figure out what they should and should not do. While accounting firms worry about the additional costs associated with multiple standards and seek to eliminate them through the adoption of uniformity, some in academia see this as an opportunity for expanding accounting programs.

Alternatively, we could consider moving the accounting educational system toward teaching general principles, which are largely independent of the specifics of the standards issued by one or another regulator from time to time. Again, we could take as our inspiration the practice of law schools, which focus on common fundamentals of property, contract, tort or legal procedure without trying to teach the statutes of the 50 states. University education, whether in law or accounting, is more appropriately concerned with the teaching of fundamentals, rather than focusing on the specific details of myriad statutes, which a practitioner can read up on when he or she moves from one state jurisdiction to another.

Students engaged in such a high-level system of education develop powers of abstraction that allow them to pick up any system of standards and apply it to specific transactions, using their own judgement based on an understanding of general principles. Given that intermediate accounting courses and textbooks have already become predominantly oriented to rote memorization of standards, even this alternative would require time and resources in order to reorient the accounting education system.¹¹

The reliance of financial reporting on written standards and their convergence in the US and the world does not hold the promise of a place for accounting in university-based, professional education. Such reliance does not help attract people who are willing to think, develop and use their judgment and take personal responsibility and earn the rewards that go to professionals who are willing to do so. Instead, accounting may be headed for the low road. We should not be surprised if the better business students begin to shy away from accounting after the SOX-induced bubble in the demand for accountants subsides. A shift of accounting practice from written standards toward social norms may help improve accounting education.

6. Thinking reforms

Countries and economies vary in their social, economic, legal and commercial structures. Social norms play important roles in all aspects of society, evolve locally, and necessarily vary across the world. The idea of using a universal set of accounting standards to yield comparable financial reports is based on three fallacies: (1) a single set of standards is best for all economies; (2) a single

¹¹ See personal correspondence from Professor Cao of the University of Washington in Appendix.

set of standards applied across all economies will yield the same results; and (3) by making this uniform set of standards principle-based, financial reports generated across the world will be more comparable.

No single rule is ideal for all, except by rare coincidence, because the relevant economic, legal and social conditions vary. If the network externalities are sufficiently large, it may be possible to find a single rule that will be advantageous on average, even though it imposes net costs on some. However, it is not easy to find such a rule except through extensive experimentation, and there is no guarantee that, as prevailing conditions change, such a rule will remain advantageous even on average.

Financial reports are the result of a combination of economic and financial conditions and events on one hand, and the applicable financial reporting rules on the other. Even if the same rule is applied to all firms in all industries and countries, the characteristics of the results will vary, depending on the economy in which the firms operate. Thus the comparability of financial reports cannot be taken for granted even if they are prepared using the same set of rules.

Principles-based standards allow more room for the individual judgment of those who prepare and audit the financial reports. Individual judgments, independently applied to the events and transactions at hand, will vary. Thus, the greater the movement toward general principles in specifying the financial reporting standards, the greater will be the diversity of interpretation, and the lower will be the comparability of financial statements. The proposition that the application of principles-based standards across the world economies will result in more comparable financial reports remains to be supported by logic or data.

The monopolies in the US and the EU deprive economies and rule makers of the benefits of experimenting with alternatives. Under a monopoly regime, one can no longer observe what might happen if an alternative method were used. If the whole world uses a single method of accounting that happens to be flawed, it would be almost impossible to produce convincing observational evidence that a better method exists or can be devised. Discovering efficient rules of accounting is a difficult problem because of the lack of reliable information about the consequences of alternatives. A monopoly restricts the amount of information available to the rule makers as well. Why should we deny ourselves the benefit of information from competitive markets? The current preference for uniformity stands in the way of the evolution of accounting, denying accountants the right and opportunity to develop new and better methods.¹²

We should assist the evolution of accounting norms by allowing regulated competition among multiple accounting rule makers who neither collude nor consciously try to get their rules to converge. Instead of being forced to use either the FAS or IFRS alone, what if each US firm could choose to use one of these two sets of standards? Standard-setting bodies could earn their revenue solely from the royalties charged for the use of their standards. Subject to light regulatory oversight, their financial viability will depend on how well their rules are able to balance the social norms and economic interests of thousands of managers and investors, as judged by their own actions. Regulatory competition prevails and works well in many domains, including corporate charters in 50 states, bond rating agencies, and higher education. For example, [Jamal et al. \(2005\)](#) examined the assurance seal market for privacy in e-commerce and found that the competitive regime in the US provided better privacy than the stricter regulatory regime of the European Union.

It has been argued that a competitive regime for accounting standards may allow, even encourage, a race to the bottom through regulatory arbitrage by managers of firms who are driven by narrow self-interest to paint a rosy picture of their performance to the public.¹³ Such arguments incorrectly assume

¹² See [Stigler \(1971\)](#) on risks associated with regulation, and [Romano \(2002\)](#) for arguments on a competitive system of laws for securities regulation.

¹³ See [FASB \(2009, pp. 8–9\)](#): “Messrs. Linsmeier and Siegel believe that there are potentially other issues to address with the current other-than-temporary impairment model. However, they would prefer to address those concerns in the joint medium-term project with the International Accounting Standards Board (IASB). They believe that risks are high that a unilateral change to the recognition and presentation of other-than-temporary impairments could create the opportunity for an “accounting arbitrage” with pressure for FASB and IASB standards to converge to the standard perceived most lenient. In addition, changes by one standard setter acting on its own fails to achieve convergence of accounting standards, which continues the challenges faced by investors in comparing global financial institutions reporting under two different accounting models.”

that the countervailing forces that act to deter rule makers from racing to the bottom are absent. First, it is in the interests of vigilant analysts and investors to identify the firms that choose standards which are inferior from their point of view, demand a higher rate of return from such investments, or withdraw their capital from them. The tendency of rule makers to slide into excessive details through successive clarifications and guidance would be counter-balanced by the reluctance of managers to subject themselves to tight straight jackets, and of investors to wade through the resulting complexity. The top-down insights of expert rule makers would be counter-balanced by the bottom-up “wisdom of the crowds” (see [Plott and Sunder 1988](#); [Surowiecki, 2004](#)). The monopoly power granted to the rule makers under the current regime is also a burden which weakens their ability to stand up to unreasonable pressures from politicians and business interests. Under a competitive regime, such pressures would be counter-balanced by the rule-makers’ ability to stand their ground, and they would direct the disgruntled to the alternative standards that are available across the street. Instead of being the first step to deal with the problems of accounting when they arise, intervention by the regulatory authority would be taken as a last resort.

The regulatory arbitrage argument against competition ignores many important examples of regulatory competition, with no sign of a race to the bottom. In the US, competition among the 50 states for corporate charters exhibits no evidence that the small state of Delaware, which holds the lions share in this market, has done so by offering lenient conditions to corporations. A competitive system would facilitate the discovery of better accounting systems through experimentation and comparative assessment over time, without eliminating the important roles of judgment and social norms.

7. Concluding remarks

Finding a balance between uniform written standards and social norms, and defining the extent of their respective roles in financial reporting, are challenging tasks. Both approaches have limitations. Standard setters find it difficult to know which standards are superior and what criteria to use for ranking the desirability of alternative standards. Societies that depend on norms and traditions also can get stuck in inefficient solutions (e.g., slavery), and it may take reform movements, even armed uprising, to release them. In accounting, we should avoid the mistake of relying on one or the other, because neither alone is likely to yield satisfactory results.

During the recent decades, the pendulum appears to have swung toward uniform written standards. We should reconsider giving social norms a stronger role and restoring personal and professional responsibility in accounting and business. Without a need for responsibility and careful reasoning, the accounting profession itself will be diminished.

We should again take up the social norm of “fair representation” as a moral compass for accounting, just as “guilty beyond reasonable doubt” is used in criminal law. Since written standards alone cannot capture either of these ideas, [Spacek \(1958\)](#) proposed an accounting court to judge what constitutes “fair representation.” It is time to devote some careful attention to the idea.

Is it possible to tame the financial reporting practices of corporations through substantial, if not exclusive, reliance on uniform written rules and punishment for violations? While the standard setters erect short sections of fence in the vicinity where the lion was last spotted, the compensation committees of the boards offer the red meat of juicy compensation packages contingent on measured performance, encouraging hungry animals to walk around the flimsy standards barriers in the open jungle of financial reporting. A body of evidence on behavior of social animals suggests that, beyond their physical needs, constraints and threats, the norms of their society play a significant role in what they do. Perhaps it is not unreasonable to think that, given the importance of our own extensive and complex framework of social structures and norms, ignoring them may not be an effective approach to restore a semblance of order to the chaos of financial reporting.

Appendix. Zhiyan (Juliet) Cao’s note on teaching accounting

(Personal communication, reproduced with permission)

I taught three sections of Intermediate Accounting III at UW-Tacoma this spring. The students had diversified backgrounds with a combination of full-time college students and working professionals in part-time program. We used *Intermediate Accounting* by Kieso, Weygant and Warfield (12th edition) as our textbook. The topics covered in this third intermediate accounting course include investment, revenue recognition, taxes, pensions, leases, cash flow statement, accounting for changes and errors, and full disclosure.

The greatest challenge was accounting for pensions. SFAS 158 had not been published in time for the 12th edition of the text and was not included in it. The pensions chapter had been organized using the off-balance-sheet approach, showing where pension liabilities and assets as memo records in the notes to financial statements. SFAS 158 moved everything to the balanced sheet, made the liability transparent, and the tricky and counter-intuitive minimum liability test unnecessary.

For me as an instructor, the major challenge of teaching pension accounting after SFAS 158 did not lie in the additional preparation for the lectures. As business environment changes, one should expect changes in accounting standards. Instead, my concern is that the new standard completely overturned the earlier approach to accounting for pensions. Students found this switch to a drastically different view of assets and liabilities disconcerting. Were the standards so radically wrong before? If so, why? Has the FASB changed to something which is really better? Will it help to have both methods around for a while and learn from experience which one is better? The only good thing about experiencing a big transition in standards while the students are learning the topic is that they start to get a better understanding of different forces that may have shaped FASB's decision and will perhaps think more independently and critically in the future.

It amazed me how many rules I am supposed to cover in the course, allowing less time for the big picture. With so much material to memorize, students ask for open-book exams/tests – not because they prefer opened-ended questions typical of open-book exams, but because they hate all the devilish details. By agreeing to an open-book exam, the instructor becomes a party to reinforcing the stereotypical image of accounting as being detail-oriented and boring. Whenever they could get the opportunity, students loved to debate accounting policies in the class.

For example, last month FASB came up with a cash flow statement-like format to break down net income into three components tied to operating, investing, and financing activities. Since I was teaching cash flow statement at the time, I devoted another half hour to discuss this new approach. Students start from the premise that if the FASB proposes something, it must have merit, and most of them supported the new approach. When I asked them if managers are the same people with same compensation contracts and same incentive to manage three components, they came up with many downsides of the new proposal.

Along the way, I asked them to think about principle vs. rule-based standards, competition in accounting standard setting, etc. I was amazed to see that when exposed to think for themselves, undergraduate students are as creative and insightful as doctoral students. I found it important to make the students believe what they do can have a positive impact on the industry. While I discussed accounting for investments in the class, the *Wall Street Journal* published an article about FASB's 800-page guidance on accounting for derivatives. It pointed out that managers tend to push the FASB for specific rules/guidance when a principles-based standard is issued. I asked the class what they would do when faced with a standard that allows room for their independent judgment in its application. After some heated discussion, they were began to see that the industry shares the blame for the increasing complexity of accounting rules with the SEC and the FASB.

In summary, it will be really useful if the students can take away three ideas from the classroom: (1) what exists is not necessarily optimal (e.g., the FASB setting everything for us); (2) what is hard to change is not necessarily undoable (e.g., introducing competition into standard setting); and (3) it is ultimately us, the individual accounting professionals, who shape the whole industry. It is a pity that students are so often drowned in technical detail that instructors do not have the time to expose them to more interesting (and important!) aspects of accounting. This is especially true for intermediate accounting. Most students plan to take the CPA exam and feel uneasy when the instructor digresses from the specific “must-be-covered” topics that may show up in the CPA exam.

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