The Summa

Debits and credits of accounting professor David Albrecht

Shyam Sunder–IFRS Critic

October 8, 2008 by David Albrecht

This is part one of an eight part series in which I review the seven IFRS critics (Sunder, Niemeier, Ball, Ketz, Selling, Jensen & Albrecht) of whom I am aware. The series continues over the next two weeks on regular posting dates, MWF.

Please be aware that you will need more time than usual to read this on Shyam Sunder, a blog essay. I’m reviewing three pieces of work by Shyam Sunder. Instead of a normal blog post of 500-800 words, this checks in at 3,400. Be assured that the read is very much worth it.

Shyam Sunder, Yale professor

Shyam Sunder, Ph.D., is truly a heavy hitter of an accounting theorist. He is a tenured, full professor at Yale and is one of the very biggest names in accounting academe. I’ve read of his work for years (his resume lists six books and over 150 refereed articles in the most highly regarded journals), and I stand in awe of his ability to get so much more out of 24 hours per day and 30 days per month than do I. He is well respected by other professors, having served as president of the American Accounting Association (national group of accounting professors). His brief bio is very revealing. It is an understatement to say that he shines much, much, much brighter on the brilliancy scale than I.

In reviewing his stance on IFRS, I will be referring to these three works (listed chronologically):

Dr. Sunder does not support the SEC decision to move the U.S to IFRS. His points are sophisticated and are mostly outside the norm of those typically found on Internet web sites and/or newspapers. However, I have tried to explain his work in such a way that a typical undergraduate student can understand. I don’t think there is any reason now to be unaware of his work.

Dr. Sunder’s earliest paper, *Adverse Effects of Accounting Uniformity on Practice, Education, and Research*, contains his most original contributions to the anti-IFRS side of the debate. It is also by far the longest of the three papers.

When I read such a paper, I first turn to the list of referenced works to quickly see where the author is coming from. After threshing the list, I see the following chronological progression of the remaining books and articles:


Now, doesn’t this make it easy to see where he’s going?

Dr. Sunder starts his paper with a recitation of the common wisdom held by many that the pursuit of uniform accounting standards across national boundaries “...is widely believed (to eventually) result in improved financial reporting, better governance and stewardship of business, not-for-profit, and governmental organizations, better informed and therefore more efficient financial markets which will direct capital towards its productive deployment.” He then cautions that he doesn’t expect this to be the result. Instead, there will be many unintended consequences, such as:

- **Decreasing effectiveness of securities markets.** “Pursuit of the goal of uniformity diminishes the effectiveness of financial reporting in stewardship and governance, and in better informing security markets.”
- **Reinforcing a follow-the-book mentality of professionals and students.** “Uniformity discourages thoughtful classroom discourse, attracts less talent to accounting programs, and ultimately, to the accounting profession. Uniform standards induce a follow-the-rule-book attitude among accountants at the expense of developing their professional judgment. Since judgment and personal responsibility are the hallmarks of a learned profession, the pursuit of uniform written standards weaken the accountants’ claim to belong in this class, as well as the claim of accounting degree programs to belong in universities alongside architecture, dentistry, engineering, law, medicine and nursing. Uniformity discourages research and debate in academic and practice forums.”
- **A death spiral leading to more detailed rules serving the lowest common denominator.** “Most importantly, uniformity encourages increasingly detailed rule-making and shuts the door on learning through experimentation, making it difficult to discover better ways of financial reporting through practice and comparison of alternatives.”

He then leads us through a few arguments that he hopes justifies his conclusions.

**First,** Dr. Sunder builds upon the observation that there is much variation in transactions. *I agree, transactions are like snowflakes, all unique but still a crystal of ice.* He says that if there is only one set of accounting standards (i.e., IFRS), it must choose between one of two guiding concepts for the larger body of IFRS if it is to have any hope of being effective. These are, (1) if two transactions differ in any way, they must be accounted for differently, or (2) if two transactions are similar in any way, they must be accounted for similarly. These two guiding concepts are mutually exclusive. The first leads to ineffective accounting because two many differences will make interpretation impossible. Too many similarities also leads to ineffective accounting because the richness of differences will be ignored. To prove this, he turns to R&D accounting. He reminds that the
goal of accounting is both to reveal that a transaction occurred, and evaluate of how effective that transaction was. Under the accounting for R&D, requiring similar accounting by two companies for expending like amounts of expenditure means that the financial statements necessarily won’t show if one has more valuable inventions than the other.

Since transactions under one set of rules can’t be accounted for based entirely on accounting for differences or entirely on accounting for similarities, then this will lead to a set of ad hoc rules. At least, I think this is what he implies from the preceding. [Words in italics are my thoughts]

Second, he reminds of the value of social norms. He explains that social norms are a group’s expectations of how individuals behave in certain circumstances. He cites the example of wearing a coat and tie to work is a social norm that makes unnecessary having detailed dress rules and enforcement. Social norms are indistinguishable from group culture. If social norms are sufficiently internalized, the the group trusts members to act properly. Trust means that legal rules and structured enforcement isn’t necessary. The trend over the last 70 years of accounting regulation has been to move from norms and trust to detailed rules and vigilant enforcement. Decades of reporting and audit failures have led many to conclude that norms and trust can no longer work. This rings true. He is the expert on social norms in accounting.

Social norms rely upon culture, and are most effective when that culture is local. When a move is made to world-wide accounting standards, it must rely upon detailed rules and active enforcement because there are no world-wide norms that will support the new world-wide accounting rules. However, local norms will continue to exist and function in various locales around the world, and it is the persistence of these local norms will make effectiveness of world-wide standards problematic, requiring more detail and enforcement of the new international rules. Crushing, or at least minimizing the impact of, local norms will result in accountants placing more reliance on blinders and strict adherence to the new rules. This further complicates the effectiveness of the new world-wide standards, because it inhibits the judgment so necessary for accounting to be effective in the first place.

He says that effective accounting can only take place when company executives can exercise choice and judgment when they report, and when social norms exist so that both trust exists, and the receipt of trust motivates proper behavior on the part of the execs making the reporting decisions. And this just isn’t going to happen if the entire world moves to a single set of accounting standards. A single set of international rules will lead to gaming and signaling by financial reporters. International rule makers will respond to gaming and signaling by adding detail to the rules to tighten them, which will be met by even more gaming and signaling. This sound like quite a vicious circle.

Third, Dr. Sunder continues in his paper by noting that the U.S. trend from accounting based on social norms to accounting based on detailed rules and enforcement has had a negative impact on accounting education, where content mastery is now king; He sees a move by the U.S. to International standards as inevitably forcing the negative trends in accounting education to continue, and perhaps even accelerate.: This is because millions will be forced into uncharted waters, and will religiously rely upon any specificity they can find.

Reliance of financial reporting on uniform written standard and their convergence in U.S. and the world does not hold promise of a place for accounting in university education. Such reliance does not help attract people who are willing to think, develop and use their judgment and take personal responsibility and rewards that go to the professionals who are willing to do so. Instead, accounting appears to be headed for the low road, and we should not be surprised if the better students in business schools shun accounting after the SOX-induced bubble in demand for accountants subsides, as it inevitably will.

Dr. Sunder concludes by saying that moving moving to a single set of world standards will deprive the world of the very thing it needs most, a set of alternative standards. Well said.

Therefore, the proposed move in the U.S. from GAAP to IFRS is a bad idea because of the unintended consequences.

In IFRS and the Accounting Consensus, Dr. Sunder expands his opposition to IFRS by considering the entire set of reasons justifying the switch from GAAP to IFRS, and then refuting the IFRS rationale, point by point. His previous paper is incorporated there, but now is part of a larger argument against IFRS. This is absolutely an essential paper for all to read, whether they are proponents or critics of moving the U.S. to IFRS.

Dr. Sunder summarizes the American SEC/FASB/Big Four consensus rationale for moving the U.S. from GAAP to IFRS:

1. The standards developed should be confined to principles and not become detailed rules.
2. A single set of high quality written standards of financial reporting applied to all companies (at least the publicly traded ones) in the world will improve financial reporting by making financial reports more comparable, and thus assist investors and other users of financial statements make better decisions.

3. To develop such standards, we should create a single deliberative corporate body consisting of chosen experts with a proper governance structure, due process, and legally assured funding, functioning under the oversight of regulatory authorities such as the Securities and Exchange Commission, the European Commission, or International Organization of Securities Commissions.

4. To this end, the operations of the FASB and the IASB should be gradually merged or converged into one corporate body and one set of standards to be called, say, IFRS.

5. This single set of standards should be practiced in the U.S., the European Union, and elsewhere, and the U.S. educational system should prepare itself to integrate IFRS into its curricula so U.S. graduates will be able to prepare, use, and audit financial reports based on IFRS.

IFRS should be confined to principles and not become detailed rules. He says that, for the most part, IFRS are simply shorter rules than what the FASB currently generates. And they are about to get longer. Sunder cites IASB members who state their intention to adopt some of the longer FASB rules. Consequently, Dr. Sunder says he really can’t figure out what IFRS proponents (the Accounting Consensus of SEC, FASB, Big Four) mean by touting principles. I interpret Dr. Sunder’s remarks to mean that there’s a lot of smoke being blown here. Like any good political group, the powerful accounting consensus has created a good sound bite with little substance.

A single set of high quality standards applied to all companies will improve financial reporting by making them more comparable, and thus assist investors to make better decisions. Dr. Sunder wonders what is meant by the term quality. A car salesperson needs to back up a claim of quality with a clear rationale for why it has quality. No member of the consensus has ever stepped forward to explain quality in financial reporting. Ouch! I think it must hurt members of the Accounting Consensus to be compared unfavorably to (used) car salesmen.

He then considers whether principles that presumably aid comparing financial statements will help managers make better decisions. His reaction is,

“A general principle is concise and calls for judgment in its application, which must necessarily vary across individuals and situations, giving rise to greater variability in applications than a more detailed rule-presumably calling for less judgment—will generate. How and why should one expect that a resort to principles instead of rules would result in greater comparability?”

Dr. Sunder is too polite to use the word ‘hogwash’, but I’m not. The Accounting Consensus claim is simply specious. Principles lead to flexibility and variability, which are the antitheses of the comparability that the consensus is touting.

A single deliberative body to develop the principled accounting standards, consisting of chosen experts with a proper structure and process, under the oversight of regulatory authorities (such as the SEC, the European Commission, or International Organization of Securities Commissions. Dr. Sunder says that having a single deliberative body, with a finite number of members, will necessarily result in a body that is limited in what it can imagine, contemplate and implement. He says that the world of accounting is simply too complex for a single organization to regulate. Because there will be no alternative accounting regulatory processes going on elsewhere in the world, there will be insufficient awareness on the sole body’s part of successful alternatives. Consequently, the chances of a single body getting right are very low. A single deliberative body, presumably smaller for manageability’s sake, is not likely to encompass as many world views as having multiple groups with their own unique perspective.

The operations of the FASB and the IASB should be gradually merged into one corporate body and one set of standards to be called, say, IFRS. Here, Sunder merges in the main conclusions of his first paper. Bringing together FASB and IASB will weaken the social norms that currently contribute to the success of each. Eventually, the end result will be a focus on more detail in the rule (which replaces the missing social norms). A focus on more detailed rules will have a negative impact on the flexibility shown by accountants and executives and will lead to rote rule following by accountants and to frequent rule-breaking on the part of corporate executives as they act in their own self interest.

This single set of standards should be practiced in the U.S., Europe, and elsewhere, and the U.S. educational system should prepare itself to integrate IFRS into its curricula so U.S. graduates will be able to prepare, use, and audit financial reports based on IFRS. Dr. Sunder says that the pendulum appears to have swung too far in the direction of uniform written standards. We should consider giving social norms a stronger role and restoring personal and professional responsibility in accounting and business. Without an opportunity to exercise responsibility and careful reasoning, the accounting profession itself will be diminished.

In conclusion, Dr. Sunder reminds that regulatory consensus views have been wrong before. There is a history of failure. There is no basis for thinking the Accounting Consensus currently being offered by the SEC, FASB and Big Four has it correctly figured out now.
An examination of the elements of the current accounting consensus leads me to conclude that most of it is built on questionable foundations. I shall also argue that, if pursued by accounting educators, it will bring grave harm to the quality of accounting education, our ability to attract and prepare talented young men and women for the profession, and further endanger the place of accounting education in our universities. Each educator should decide on his or her own after thinking about what standardization and monopoly accounting and auditing have done to accounting education and the profession, and whether moving further down this road will help us serve our students and society better.

In his third paper, SEC’s mandate will lead to a monopoly, Dr. Sunder provides a succinct highlight reel for the Financial Times newspaper describing why he thinks the U.S. should not switch to IFRS. He seeks to rebut a pair of the SEC’s claims, that “The move would integrate the world’s capital markets by providing a common high-quality accounting language, and increase confidence and transparency in financial reporting.” His basic position is that neither a high quality set of accounting standards, nor increased investor confidence will result. Mostly, though, his conclusion is that the move will decrease the quality of American financial reporting. To support his position he puts forth the following reasons.

1. IFRS are less enforceable because they provide more room for judgment by managers doing the reporting and by auditing firms. An American manager might ask, ‘Where in IFRS does it say I can’t do this,’ with unfortunate results.
2. The characteristic of being of high quality depends upon who is doing the evaluating and what is their set of priorities. I like pizza, but you might not.
3. With two standard setters, each can look at the other and learn from the other’s experience. In other words, there is no need to make the same standard setting mistake twice. If the U.S. moves to IFRS, then the U.S. financial reporting environment is doomed to suffer from the mistakes of Europe, a fate that wouldn’t occur if only the U.S. had an opportunity learn from Europe’s prior (misbegotten) example.
4. Comparability of financial statements across more than 100 countries is a “pipe dream” because of the interaction between standards and the unique market, financial, governmental, legal, and commerce environment of that country. Such interactions make impossible financial statement comparability. Since there will never be across border financial statement comparability, there is no reason to cite it as a reason for adopting IFRS.
5. American business will react to the change in standard setting in unforeseen ways. It simply can’t be predicted that the U.S. financial reporting environment will improve with a change in standards. American execs must be ready to start singing, ‘You ain’t seen nothing yet, oh-oh-oh babee, you ain’t seen nothing yet.’

To my way of thinking, it is fairly easy to see how these points combine to refute the SEC goal of creating a single set of high-quality accounting standards. He offers no explanation to show clearly how his points refute the SEC goal of increased investor confidence. Although Dr. Sunder concludes by saying that the world is best served with two universes of accounting standard setting, what he really means is that the U.S. is better served with GAAP and not IFRS. He’ll let the rest of the world tend to itself.

I am so grateful that an academic with the stature of Shyam Sunder as stepped up in opposition to the SEC/FASB/Big Four push to scrap U.S. GAAP and replace it with IFRS. When all are kow-towing to the politically powerful, it is indeed admirable for a great mind to stand up and say that the emperor has no clothes. Thank you so very much, Dr. Sunder.