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SOCIAL NORMS VERSUS STANDARDS OF ACCOUNTING*

Abstract

Historically, norms of accounting played an important role in corporate financial reporting. Starting with the federal regulation of securities, accounting norms have been progressively replaced by written standards. While social norms are maintained through an informal process of social as well as internal sanctions, standards require more formal enforcement mechanisms, often supported by implicit or explicit power of the state to impose punishment. The spate of accounting and auditing failures of the recent years raise questions about the wisdom of this transition from norms to standards. Many aspects of family, local, professional, social, national and international behaviors continue to be governed by mechanisms in which norms play an important role. It is possible that the pendulum of standardization in accounting may have swung too far, and it may be time to allow for a greater role for social norms in the practice of corporate financial reporting.

1. Institutionalization of Rule making

Since the 1960s, accountants have been occupied with keeping the government out of the business of determining financial accounting practices. This concern has been overblown and misplaced, and has led to the creation

* Copyright © 2005. All rights reserved. Preliminary draft prepared for presentation at the International Conference on General Accounting Theory III: Towards Balanced Development at Cracow University of Economics, May 28–31, 2005. Do not quote without permission. I am thankful to Karim Jamal and Richa Shyam for discussions. Please send your comments to Shyam.sunder@yale.edu.

of accounting institutions that, in pursuit of their assigned goals, lost sight of the limitations of what can and cannot be achieved by written accounting rules. Instead of pushing financial reports towards fair representation, the rapidly expanding accounting rulebooks created by such institutions have often served as a “road map for evasion” for the unscrupulous, frustrating the intent of the standard setters.

1.1. Keeping the Government Out

Keeping the government out of accounting rule making has been a major concern of accountants and business executives over the past four decades. I have not seen an explanation of this argument beyond the general dislike of “government-imposed” rules that might constrain what business can do. There are two problems with this general dislike. First, a great many “government-imposed” laws and rules not only benefit business, they are essential for many types of business to prosper, even exist. Imagine the automobile industry without rules of traffic; aircraft and airline industries without the Federal Aviation Administration; the restaurant industry without health and sanitation regulations; the environment industry without the Clean Air Act, and the audit industry without the federal securities laws. They would be different, if they existed at all. It is suicidal for businesses and accountants to work themselves up in lather over a general dislike of government rules.

Second, attempting to keep the government out of accounting rule making in the seventies was four decades too late; the federal securities laws had already given the Securities and Exchange Commission (SEC) the authority to write the accounting rules. Besides, the accountants volunteered to take over only a part of the work¹. With the statutory authority already

¹ See Bernstein (2001) for an analysis of how the cotton industry in U.S., and internationally, developed its own private legal system, outside the Uniform Commercial Code in U.S. and outside the Convention on the International Sale of Goods internationally. The industry’s private legal system and institutions necessary to administer it are judged by her to “work extraordinarily well.” Written rules specific for the cotton trade have a bright-line character on bilateral contract fulfillment. Disputes are refereed to a prompt and inexpensive arbitration narrowly focused on written rules. Disputes about the quality of cotton, subject to more than forty attributes that require expert judgment, are refereed

in its hands, accountants' eagerness to keep the rule making in private hands simply made it easier for the SEC to let the Financial Accounting Standards Board (FASB) take the hard knocks for making tough decisions, and enter the scene as an arbiter when its constituencies objected to the rules proposed by the FASB. Without a legal mandate and eager to keep the government out, the FASB ended up running harder and harder to please the SEC, proposing rules more detailed than what the SEC itself could have proposed or enforced.

1.2. Structural Weakness

Making accounting rules through a private agency suffers from another serious problem. Unique among agencies that make rules, rule making is the only function of the FASB. A permanent rule making bureaucracy with no other functions must make rules to justify its budget and existence. The FASB's structure had an additional weakness in that it depended on revenue from the sale of its publications for a good part of its financing. In the case of this agency, the challenge to publish-or-perish was not merely metaphorical, but real. Having established the agency, the accountants committed themselves to have to live with its output which has accumulated into ever thicker volumes over time.

1.3. Incentives Created by Private Rule making Institutions

Finally, the very existence of the rule making agency encourages accountants to submit requests for "clarification" instead of persuading their protesting clients on the basis of professional judgment and general acceptance. When the client disagrees with the auditor on accounting treatment of an event or transaction, it is easy for the client to ask: Can you show me the rule which says I must do this, or I can't do that? Any response to such

to a separate arbitration panel. Non-legal sanctions include association and exchange membership rules, a close-knit social network in which information about contract disputes and defections is rapidly disseminated. Written code, combined with compulsory arbitration and social network help induce, maintain, and restore cooperation and promote an efficient market for cotton. See Shield (2002) for an anthropologist's analysis of the diamond trade in New York where social norms, trust and arbitration play important roles.

a question which is based on a written statement of general principles, or on auditor's judgment about the norms of accounting, is subject to the counter argument that the general rule does not apply to the case at hand because of one or another of the myriad specificities. Yes, it says "Thou Shalt Not Steal." But I only borrowed the car, and had intended to inform the absentee owner upon his return. Where does it say that borrowing means stealing? A client always has an endless list of such specificities that he can use to argue with an auditor who has a weak hand in dealing with his own paymaster. Active competition in the market for audit services forces the auditor to constantly look over his shoulders if he is about to lose the client to a more accommodating competitor. Since the Code of Ethics was changed in 1979 to promote competition in the audit market, audit firms have rewarded their partners for "rainmaking," not for the qualities that prevailed in an earlier era—technical mastery, professional judgment, and the respect they commanded from their colleagues inside and outside the firm.

1.4. Effect of Rule Makers on Behavior of Auditors

The existence of a full time rule making body suited the rain making audit partners well. Social norms of accounting and professional judgment lost favor as the auditors, pushed by their clients to cite line and verse from the rulebook, began to call the FASB to "clarify your rules." If the FASB did not respond, as it rarely could, at least in time to address the auditor's inquiry, the auditor could let the client have his way, secure in the knowledge that he had tried and failed to get a clarification from the rule makers. Had the rule making body not existed, the auditor at least would have had to worry about the fair representation requirement of the securities laws. By its very existence, the FASB became an unwitting instrument of promoting "if it is not proscribed, it must be okay" attitudes in financial reporting.

1.5. Hide-and-Seek with Wall Street

The consequences of rule making bodies went beyond the behavior of corporations and auditors. Investment bankers would call the rule makers and try to obtain assurance about the transaction they had devised with the goal of evading one or another aspect of fair representation would pass the

muster. If they could get an affirmative answer, they could collect fat fees from their clients; otherwise it was back to the drawing board for minimal modifications that might clear the bar. The rule book of the accountants thus became a road map for evasion from fair representation. Given their intent, the Wall Street financial engineers calling the FASB to clear their plans, is analogous to a thief calling a homeowner to ask when he plans to leave for work.

1.6. Rule Making Monopolies

The monopoly rights given to the FASB in the U.S. (and the International Accounting Standards Board or IASB in the EU) deprived the economies, and their rule makers, from the benefits of experimentation with alternative rules and structures so their consequences could be observed in the field before deciding on which rules, if any, might be more efficient. Rule makers have little idea, *ex ante*, of the important consequences (e.g., the corporate cost of capital) of the alternatives they consider. Representations made to them by various constituents tend to follow predictable arguments that serve their respective self-interests, and do not enlighten the rule makers about the consequences. Such arguments often turn out to be hollow posturing after the new rules are implemented. Yet, posturing by the constituents hardly implies that the new rules make things any better. We do not know, and in absence of direct competition among rules cannot know, which rules are better. Yet, the regulators and governments around the world are rapidly enclosing their respective jurisdictions to grant monopoly rights to one or the other rule making body. These monopoly regimes, and the cooperation taking place among them, do not bode well for evolution towards more efficient financial reporting regimes (Dye and Sunder, 2001; Sunder 2003a, 2003b).

In summary, the practice of financial reporting has shifted its focus away from social norms in favor of written prescriptive standards. Several factors—misunderstanding the role of social norms in law, the popularity of accounting and stock market performance-based compensation for senior managers, the promotion of competition in the market for audit services, and the creation of full-time private sector rule making bodies whose sole function is to make accounting standards—all played a role in this shift.

The events of recent years suggest that this shift might have gone too far. Perhaps it is time to review our system of financial reporting, its institutions and their relationship to corporate governance and audit markets, to decide how we could make adjustments to move forward to a better, more efficient and stable system.

2. Accounting and Classification

2.1. Errors of Inclusion and Exclusion in Classification

In any system of classification, e.g., a body of rules or law, taxonomy, or social norms, it is easy to confuse detail with precision. One does not imply the other. If it did, we could function better with hundred or a thousand commandments, not ten. All classifications must deal with the errors of inclusion as well as the errors of exclusion (Sunder 1984): the greater the detail, the greater the errors of exclusion; the lesser the detail, the greater the errors of inclusion. If the problem is sufficiently well-specified, it may be possible to identify an optimal level of detail, but such a solution is unlikely to be the corner solution.

Objects or events of classification have many attributes which are relevant to the purpose of classification. For example, a librarian or a bookstore may consider the language, genre (history, biography, fiction, travel, poetry, etc), target age group, and hard or soft cover as the four relevant attributes of books. What would be a uniform system of organizing the books in the library or the bookstore? An organization by genre would force the young readers to spend extra search effort compared to a store where there was a separate section displaying books for the young. An organization by the age group of readers will force those who wish to look for biography to search across sections by age. Of course, books could be cross-classified by multiple criteria, imposing extra search costs on those who have not yet made up their minds if they wish to read biography or fiction, and whether they care about the type of book cover.

2.2. Basic Records Approach

Goetz (1939, 1949) and Schmalenbach (1948) suggested the idea of making basic accounting records available for alternative aggregations by various users. Computer technology has finally developed marvelously efficient software solutions to this problem in the form of relational databases (Colantoni et al. [1971] and Dunn and McCarthy [1995]); and libraries and bookstores have been early adopters of such technologies. Fortunately, accounting classifies and represents physical and non-physical resources through symbols, and the database technology can already address the problem of cross classification. Computers are capable of storing information about various relevant attributes of resources and events in an organization that allows users to obtain all possible classifications and cross classifications these attributes would allow. Why don't we simply use this technology?

Broader access of disaggregated data so users can re-aggregate it in alternative ways for their own purposes would mean access to additional information to shareholders and others. Such a transfer of information rights, now held by the managers, is not a matter of mere procedure or efficiency. It may also disseminate proprietary information and constrain the actions managers of the firm can take without divulging their hand.

2.3. Clear Rules or Road Maps for Evasion

Any body of law or rules has to strive for clarity and enforceability without becoming a road map for evasion. It is reasonable for rules to specify the documents necessary for a person to cross the borders of a country. It is not reasonable to specify the schedules and routes of border patrols posted to mitigate illegal immigration. Bright-line accounting rules (e.g., 75 percent of estimated economic life of leased property, 3 percent ownership in special purpose entities, and 20 percent ownership for equity accounting) serve as road maps for evasion of fair representation in financial reports. By removing the uncertainty about whether a given accounting treatment of a transaction designed for evasion will meet the fair representation standard, such hard numbers in rules provide the guide posts for financial engineers to work their way around the ultimate goal of fairness.

Given the deliberate and premeditated nature of financial fraud and misrepresentation (and other white color crimes), “clarifications” of the rules invite and facilitate evasion. Laws are written to consciously avoid this trap; writers of accounting standards could do better by being more aware of the problem. Competitive auditors, pressed by their paymaster clients, find it convenient to resort to, indeed demand, endless clarifications of written rules. When the writing of new rules is their sole function, agencies become unwitting accomplices of the auditors, managers, their lawyers and investment bankers. They must produce new rules to justify their existence. In contrast, legislative bodies do not have to pass new laws (excluding budget and appropriations); they do so only when there is sufficient agreement.

3. 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 group². 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.

² “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” (R. Posner 1997, p. 365).

3.1. 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 any 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 both unnecessary, as well as impossible. The second sentence of the paragraph is subject to the same caveat. 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 are³. 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 financial community, and their general disapproval of deviations.

3.2. How Do Norms Work?

How can social norms, subjective and incompletely specified, work in highly contentious environment of financial reporting where a great deal of money might be 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 “trading on non-public information.”

³ For example, Paton and Littleton (1940). They use “Standards” in its title, 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).

3.3. Courts and Juries

Juries routinely decide cases in which stakes are as high, or higher, as in financial reporting, and conclude if an accused is guilty of murder or assault or fraud beyond reasonable doubt⁴. Lawyers do not proceed to replace these norms by clear and authoritative statements which are complete and objective. Indeed the U.S. constitution—a document that covers the entire governance system for the republic—has less than 5,000 words. The United Kingdom has no written constitution. A great part of the governance of both countries depends on norms. Do accountants deal with greater stakes? Why have accountants pursued the displacement of norms by written rules in the fruitless unending chase of completeness, objectivity, and uniformity?

When a jury is asked to reach a verdict on whether the accused is guilty beyond reasonable doubt, care is taken to minimize the chances that its members have any conflicts of interest. The prospective jurors are asked to reveal any such conflicts, and the prosecuting and defense attorneys cull any members who may have such conflicts. Care is also 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 any 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 reasonable doubt” but 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.

3.4. 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 Com-

⁴ 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.

mission 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 must take the case to court, where the final judgment is rendered, in spite of far-from-complete definition of “insider trading” as well as “reasonable doubt.”

3.5. Constitutions

Even written constitutions are far-from-complete specifications of the rules. Judgments of the courts in such 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 absence of the former, the latter appears benign when there is no better alternative.

3.6. 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 seven decades, this process has been regulated by the SEC under a collection of federal securities laws, to which the Sarbanes Act of 2002 is the latest addition. I shall argue that the interactions of managers, auditors, and regulators with conflicts of interest, the absence of procedural rigidities and location of ultimate authority, have rendered financial reporting unfriendly to the use of social norms during the recent decades.

3.7. Conflict of Interest

In preparing the financial reports, professional managers are put in a conflict-of-interest position, especially when their compensation, continuation in the job, and their 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 certified 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 norms⁵. 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

⁵ 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.

market for audit services mutually reinforced each other in intensifying the demand for “harder” financial reporting standards to replace the “softer” social norms.

3.8. Final Authority for Decision

Autonomy of decision making with no second-guessing supports the use of norms. Autonomy does not mean there are no consequences of making errors of judgment. While the decision of the jury is not subject to second-guessing, even the jurors must think about how their decision will appear in the eyes of their friends, neighbors, and family; and in the case of better known cases, the media. 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 the 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 Act of 2002 does not recommend that the internal accounting and auditing structures of the firm bypass the CEO and report directly to the audit committee of the board of directors, or to an outside regulatory agency such as the SEC.

4. 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 standards intended to be, but not yet reached⁶. 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. The 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 another⁷.

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:

⁶ http://www.cilc.nl/focus_13b.html

⁷ 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 I use the term *norm* in the present paper.

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 practice⁸. It means continuing effort to determine appropriate practice and to narrow the areas of difference 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.

In contrast to this social norms perspective, the standardization project in accounting has taken on the path of normative laws that prescribe account-

⁸ 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 58th edition was published in 2004 (footnote added by the author).

ing methods and procedures that are intended, but not yet reached. In spite of years of thoughtful discussion and commentary on the undesirability of such a route⁹, why and how did accounting fall into this self-constructed trap?

5. Beliefs about Enforcement and Effectiveness

When dentists install braces, they are careful in applying only a limited amount of pressure to align our 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 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; greater the punishment, greater the resources devoted to protect oneself from the punishment. One may be perfectly willing to pay a \$15 fine for 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 the recent decades, the enforcement powers behind the accounting standards have been raised to progressively higher levels. 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. Even more damaging, the sense of personal and professional responsibility for fair representation on part of corporate

⁹ “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. It 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).

managers, accountants and investment bankers has been substituted by 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 the assumption has not yet been marshaled.

6. 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.

First, rewarding senior managers who exercise any control over the accounting and reporting functions, on the basis of such reports, endangers the accuracy of the reports. One possibility is to restrict such managers to flat compensation or a bonus which is not linked to either accounting numbers or the derivatives of accounting numbers such as stock or option prices. There is the counter-argument that such delinking will eliminate managerial incentives to work harder to improve performance. However, this counter-argument needs some evidence of a causal link between larger bonuses and better corporate performance attributable to hard work by managers. Such evidence has been conspicuous by its absence.

An alternative possibility is to take the control of accounting and reporting functions out of the hands of the senior management, and transfer it to the audit committee of the board. If audit committees cannot be sufficiently free from the influence of the managers, such control could be transferred to outside accountants, or as originally proposed in securities legislation, to a government agency such as General Accounting Office. Professional accountants, unrelated to the management of the firm, could then exercise their own best professional judgment in the context of social norms of accounting to prepare corporate financial reports.

Second, a system in which the auditors depend on the discretion of the people they are supposed to monitor is not friendly to a system of social norms. Promotion of active competition among auditors for clients and employees, especially when we consider the lack of observability of audit

quality, is also hostile to a system of accounting norms. The Sarbanes Act of 2002 has taken some steps to reduce the direct control of managers over outside audits, though the effectiveness of these reforms beyond the initial few years of excitement remains to be seen¹⁰. However, nothing has been done to reduce active competition among audit firms, which continues to remain a threat to developing a stable system of social norms of financial reporting.

Third, social norms need a moral compass. “Fair representation” is the financial reporting equivalent of “guilty beyond reasonable doubt.” After considering the myriad details and complexities of business transactions, managers, accountants, and auditors must ultimately use such a compass to reach their final judgment. Just as even the best legal minds cannot write laws that will define “beyond reasonable doubt” for purposes of general application, the best accounting minds cannot capture “fair representation” in any set of written standards. The solution to such a problem is individual responsibility to make one’s own best judgment, and, in cases of dispute, turn to a jury for an independent determination which is not subject to second guesses. The late Leonard Spacek, a one time head of Arthur Andersen & Co. and a leader of the CPA profession, proposed an accounting court as a solution. Perhaps it is time to revisit that proposal.

Fourth, the process of developing accounting norms could be assisted by a competitive system of accounting rule makers. As a transitional measure, the regulators in each accounting jurisdiction could announce a short list of accounting rule makers whose rules would be acceptable to the regulator. For example, the SEC could announce that the organizations under its jurisdiction are free to prepare their reports so they conform to the standards issued by one of a few rule making bodies such as the FASB and the IASB. The operations of such bodies could be financed by the fees they gather from those who freely choose to use their standards in preparing the reports. Such a competitive system will force the standard setters to think hard about the consequences of their proposals for the reporting organizations, especially their cost of capital. The competition may also lead to endogenous convergence in their prescriptions which may not be such a bad thing. On the other hand, the prescriptions of various organizations may diverge, with

¹⁰ By the time of Enron, WorldCom and Fannie Mae, the Foreign Corrupt Practices Act of 1977, passed as a part of post-Watergate reforms, was almost forgotten.

each surviving organization having its own clientele in a special niche. In either case, a competitive system of setting standards would be consistent with a system of endogenously determined social norms of accounting.

Unfortunately, the U.S. has granted an effective monopoly to the standards issued by the FASB. The creation of the Public Company Accounting Oversight Board (PCAOB) has made things even worse by requiring each publicly-held firm to pay a compulsory fee for the maintenance of FASB's monopoly. This is inherently problematic. The guaranteed fees will make the FASB even less responsive to the acceptability of its prescriptions as norms of accounting, the good intentions of its members notwithstanding. When the revenues of an organization are not linked to how well its constituents like its output, it is not likely that the organization would be pushed to make the hard decisions and right choices at the margin. Similarly, the EU has already granted monopoly rights to the standards issued by the IASB. These monopolies do not bode well for a system of experimentation and the evolution of accounting norms.

The Sarbanes Act of 2002 has been the most important government response to the major accounting and auditing failures of the recent years. Aside from adding "watchmen to look over watchmen," and imposing considerable additional costs, this act does little to address the fundamental factors to which these failures can reasonably be attributed. We could begin a serious discussion of how to address these factors by understanding the mutually interacting roles of rules and norms in accounting on one hand, and of legal enforcement and personal responsibility on the other.

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