"TRUE AND FAIR" AS THE MORAL COMPASS OF FINANCIAL REPORTING☆

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ABSTRACT

Experience with the 75 years of development of, and increasing reliance on, written standards of corporate financial reporting suggests that balancing them with community's social norms may be a better option. "True and fair" override of written standards could serve as the moral compass of financial reporting.

> The study of human institutions is always a search for the most tolerable imperfections.
> Edmund Burke.

Practice of accounting faces three challenges: (1) developing social norms of accounting to balance our reliance on the written standards; (2) restoring the role of the accountant as a professional with self-discipline and

☆This work is based on the Keynote address to the American Accounting Association Ethics Symposium, New York, August 2, 2009. Revised September 15, 2009.

Research on Professional Responsibility and Ethics in Accounting, Volume 14, 3–11

ISSN: 1574-0765/doi:10.1108/S1574-0765(2010)0000014004

responsibilities that extend beyond his business self-interest; and (3) developing "true and fair" criterion as the moral compass for financial reporting.

Until a few decades ago, financial reporting had long been a matter of social norms. However, since the passage of the US federal securities laws in the 1930s, financial accounting has gradually and steadily shifted away from social norms toward national standards, and now toward international standards. In the United States, the federal securities regulations induced a transition from the norms modeled toward written standards in accounting thought, practice, regulation, instruction, and research. Europe is on a parallel track in the same direction. Generally Accepted Accounting Principles no longer imply general acceptance in the plain English sense of the word. Now, they have become a capitalized proper noun GAAP. How does one know if something is generally accepted? Because someone with authority says so. Whatever is printed in the authoritative book is GAAP. This is a distortion of the very notion of social norm and general acceptance.

Social norms of a group are shared expectations of its members about behavior of others in the group. Etiquette, dress, table manners, grammar, language, customary law, and private associations, are all matters governed largely by social norms. Many aspects of business are also governed by social norms. The essence of social norms is observable behavior and not beliefs. What one believes is not a matter of social norm; what one does is. Norms need support of a broad consensus and not a mere majority of 51 percent. Simple majority might be sufficient for a rule, but not for a norm. Norm is what almost everybody expects others to conform to.

Consider dictionaries as an example. They earn respect and authority, and attract a following, by their contents, not by wielding a power to punish deviant use of words. Why is the *Oxford English Dictionary* held in such high regard by so many in the world? No authority requires one to follow a particular dictionary. Dictionaries earn their respect if millions of people find that they provide useful guidance on language. Many dictionaries compete through a bottom-up, not a top-down, process, and choose if they serve general or specialized niche audiences.

While social norms are maintained by both internal and external sanctions, laws and standards are enforced by authority with the power to punish – "do this or else." Most enforcement of social norms is internalized, and the rest takes the form of informal social sanctions.

Reasons for the transition from the presecurities laws regime dominated by norms of accounting to written standards regime in the last 75 years are unclear. Even more puzzling is the absence of a debate about the pros and cons of this transition. Why is there so little discourse and critique of the rationale for moving in this direction? We see widespread continued use of norms in our personal, professional, neighborhood, national, and legal aspects of life. Would it not be better to seek a balance between the norms and the standards of accounting, and if so, what would such a balance look like?

Consider an accounting example of social norms. The first attempt to write standards in corporate financial reporting was undertaken shortly after the Securities and Exchange Commission (SEC) was created and a Special Committee of the American Institute of Certified Public Accountants (AICPA) worked with the New York Stock Exchange. May (1943) and Zeff (1972) have written about the Committee's proposal consisting of six rules, each stated in one paragraph. The first rule was: "Unrealized profit should not be credited to income account of the corporation, either directly or indirectly, through the medium of charging against such unrealized profits amounts that would ordinarily fail to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected ..." (Bulletin of American Institute of Accountants, 1934) What's wrong with stopping there and going no further? How much clarity have we attained after 75 years of trying to clarify this sentence? Tell us what you mean by realization. You write down a few more sentences and suggest sales as a criterion for realization. When is the sale completed? You say: "When it's shipped out." "When exactly is the shipping completed?" And so on we have proceeded, with no light yet at the end of this tunnel.

One New Year's night, I was at a friend's place for a party. My friend's wife worked for a corporation in New Jersey and she was not home. She was the shipping manager and midnight was a crucial time to get the trucks out the door so the goods could be included in the revenue for the year!

Realization of profit on sale, like any other rule, has an intrinsic, irreducible subjectivity; complete specifications of the conditions for realization are unnecessary as well as infeasible. There's no authoritative source and all are free to propose their own norms that may or may not be accepted. Authority derives not from the code but from general acceptance of the norm by the financial community, and the community's disapproval of any deviations. One may boast to buddies at the club about cutting the corners on a rule, but not on a norm.

Today many of us in the accounting profession and academe have come to view the extent of standardization as a measure of accounting progress with the attitude: our accounting is better because our rulebook is thicker than yours. The SEC, the International Accounting Standards Board (IASB), and others talk about high quality standards without telling us anything about what they mean by quality of accounting standard and how one can determine the quality of a standard.

Baxter (1953), a respected professor from the London School of Economics, analyzed the corrosive effect of authority on the accounting profession over half-a-century ago. His ideas largely forgotten or ignored, there has been little research and debate on the consequences and desirability of the ongoing shift of balance from norms toward written standards (Sunder, 2007).

Legal scholarship and practice are acutely aware of the limits of the efficacy of written laws and rules. When it's not possible to write a rule that will improve the state of affairs compared to the judgment-based regime, the law leaves the judgment in place. After the lawyers have presented their evidence and arguments according to law, the judge asks the jury: Is the accused guilty beyond a reasonable doubt? The jury of lay men and women make the most important, even life-and-death, decisions. The jury might ask, "Your Honor, how much doubt is reasonable – 1, 5, or 10 percent?" If the judge were an accountant, he might say 3 percent, and lead to the special purpose entities of Enron. Those thousands of entities were the result of the 3 percent rule for special purpose entities written by the standard setters. But judges are smart; they tell the lay jury to decide on the guilt of the accused using their own community norm. The law does not attempt to clarify answers to such questions. Nor do they set up institutions for issuing clarification and guidance. People who write and practice law understand all too well that the consequences of clarifying such questions would be even less desirable than the consequences of leaving the answers to the best judgments, even if the judgment is to be exercised by lay people.[1]

The SEC and the US Congress refuse to clarify the definition of insider trading beyond "trading on non-public information." Many have tried to get the SEC to clarify what is nonpublic information over these 75 years. The Commission hasn't budged. But when it comes to accounting, the SEC seems all too ready to issue guidance. Consequences of such clarifications, too, are even less desirable than the consequence of leaving such matters to judgment. My daughter Richa, a lawyer, tells me: "Papa, you guys are creating roadmaps for evasion." It's like posting the lunch schedule of the bank guard on the door.

Who asks for guidance, and for what purpose? Many, if not most, derivative securities are designed specifically to get around accounting rules on recording liability on balance sheets intended to assist the readers to assess the risks. Many transactions and special purpose entities are created for that purpose, and their designers need clarification of rules to make sure that their designs will achieve the goal of frustrating the intent of the accounting rules. We do need written documentations and rules – passport and immigration, for example – for many aspects of our lives. However, we must ask if each additional clarification makes things better or worse. Can the legislature write down clear rules for what a policeman should consider suspicious behavior? The accountants' rulebook grows with their efforts to clearly document such matters.

Many accountants have sought explanations of this phenomenon in essentially empty distinctions between principles versus rules-based standards of accounting. The IASB started its work about 20 years after the Financial Accounting Standards Board (FASB) did; the FASB is further along on the growth curve of its rulebook than the IASB is on its curve. The appropriate comparison of today's International Financial Reporting Standards (IFRS) is with where the FAS stood 20 years ago. Given another 20 years of growth, the IFRS may also get close to where the FAS is today. Which other profession takes 2,800 pages to list its principles, growing at a rate of a few hundred pages each year? The very existence of rule-making institutions encourages requests for clarification, just as placing a complaint booth on the campus mall encourages more complaints. Creation of permanent standard-setting bodies like the IASB and the FASB in accounting is like installing a complaint booth. Imagine the following conversation:

Client: "Why can't I recognize this revenue?"
Auditor: "In my best judgment, it would not be appropriate."
Client: "Your judgment will cost my $5 million in bonus. I don't want your judgment. Is there a rule you can show me?"
Auditor: "If you don't care about my judgment, I resign this engagement."

Instead, the existence of the FASB and IASB encourages the auditor to ask the Boards: "Please clarify the rule and provide guidance so I can tell my client: I would like to support you but I am forced to deny you this revenue. I am at your service but my hands are tied." This dynamic is the source of the demand for guidance, clarifications, and increasing detail. The very existence of rule-making institutions lowers the professional accountant's resistance to client pressure.

General principles are always under question. The scriptures say "Thou shall not steal." But what do you mean by steal. I just borrowed your computer while you were away. I meant to return it when I was done with it. Where does it say this is stealing? Show me where stealing is defined. We know that the wisdom of defining stealing is questionable. Yet, that's exactly what we are doing in accounting. Human society has known this problem for millenniums. Why do we have only 10, not a 100 or a 1,000 commandments? There are good, substantive, and common sense reasons for not clarifying such matters and leaving them to individual judgment, interpretation, and social norms.

Promotion of competition among auditors made matters worse after the US auditors' code of ethics was changed in 1979. Audit partners came to be rewarded for rainmaking and not for their technical mastery or professional judgment. The effect of the existence of rule makers on the behavior of auditors is that, under pressure from their clients, they ask the FASB and the IASB to issue additional guidance and clarification. Under such a system, it is easy to think that anything that is not specifically proscribed must be permitted.

Finally, there's the game of hide-and-seek on Wall Street. The investment bankers call the FASB to ask for clarifications in order to devise instruments to help them go around the rules. The day the FAS 13 on leases came out, I was at the University of Chicago, headed for my Intermediate Accounting class. Criteria for capitalization of a lease were 90 percent of fair value, or 75 percent of the economic life of the asset. It should not take an average student long to redesign the lease agreement such that the debt or liability does not show on the balance sheet under the lease accounting rules. The FASB had spent many years to write that rule and has revised it often since 1976 to form a substantial volume by now. What matters is the process, not a particular choice of words in accounting rules. When Wall Street and the City of London call the FASB and the IASB for clarification, it amounts to a burglar inquiring when you plan to be away from home.

The monopolies in the United States and European Union for making accounting rules deprive these economies and the rule makers of the benefits of observation from experimentation of the alternative. IFRS is a big deal in year 2009. What will be the consequences of granting IFRS the status of a monopoly in the world? There will be one set of standards for the whole world. What if that standard is wrong? Who would be able to tell them that there is something better? How would one make the argument that a hypothetical alternative is better? How shall we know if there is no alternative in the field? Suppose Apple computers were judged to be the best in the world. Does it make sense to grant Apple a worldwide monopoly? The quality of computers will go down, and the prices will rise within a few years. Creating monopolies does not help. Why do we want to deny ourselves the benefits of information gained from competition in accounting standards?

The dependence on rules undermines accounting as a profession because the essence of a profession is judgment, and personal responsibility for making such judgments. A professional's loyalties extend beyond the personal business interest to the discipline, customers, and clients. Without ignoring their business interests, professionals must find a balance between the two. For example, a physician who pursues his business interest without regard to allegiance to his oath is not regarded as a professional. They take the Hippocratic Oath to put the interests of their patients before their own personal interests.

In accounting, we have struggled with the business and professional motivations, under pressure of their special legal liabilities, their reluctance to accept responsibility for fraud detection, and accusations of conflict of interest. There is a reluctance to defend audits on the basis of reasonable professional judgment given the evidence available at the time auditors make their judgment. Instead, they try to defend themselves by writing specific rules of auditing and accounting. A doctor might say, "Yes, I chose this treatment because, based on the information available to me at the time, this was my best judgment." How often do accountants use the best professional judgment defense? I would like to see some examples. They seem to prefer to seek protections in the written accounting and auditing standards instead of their professional judgment. But written standards can only go so far because, beyond certain levels, they begin to encroach on their professionalism. But few would want to be treated by a box-checking physician. Abandoning the professional judgment, defense has deemphasized professionalism in accounting and makes accountants appear to be hiding behind the rules. And the government policies of the recent decades haven't helped either.

Returning to the beginning, what will it take to restore the role of accounting as a profession with self-discipline and responsibilities that extend beyond its business interests? How can accountants remain a profession and not get reduced to a trade, like plumbers or electricians? What are the consequences of rule-making for what we do in our classes? Once auditing and accounting get codified into written texts, shall we teach accounting or just accounting standards? If we turn to teaching memorization of standards, as opposed to making comparisons and judgments, how long will our universities allow accounting to stay in their curricula?

Instead of balancing the written standards with the social norms, total dependence on the written standards after the last 75 years has taken us on the wrong path. The profession needs a moral compass. In law, guilty beyond a reasonable doubt serves that function. This process keeps the statutory and common parts of the law in balance to help maintain order in society. While everyone does not agree with every decision, the general lay acceptance of judgments of the courts is essential. And this is where financial reporting has failed. How can accountants earn lay acceptance? Thousands of pages of written rules will not protect us from the wrath of society if the final outcomes are not seen as true and fair. This is what the president of the United States promised the public on July 9, 2002 in the aftermath of Enron, WorldCom, etc. "We are moving corporate accounting out of the shadows so the investing public will have a true and fair and timely picture of assets and liabilities and income of publicly traded companies." In these seven years, have we gotten any closer to the "true and fair" that the president promised? If not, why not? Increasing dependence on written standards is unlikely to move us closer to that goal.

NOTE

1. The federal government wrote mandatory sentencing guidelines for federal judges in the hope of bringing greater uniformity to punishments meted out to the convicted felons. These mandatory guidelines were recently abandoned and made advisory to judges, United States v. Booker, 543 U.S. 220 (2005).

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