

Shyam Sunder

INTERNATIONAL AND NATIONAL STANDARDS AND NORMS OF FINANCIAL REPORTING: MONOPOLY OR COMPETITIVE COEXISTENCE¹

Abstract

In recent decades, financial reporting has shifted away from reliance on social norms towards predominance of written standards enforced by authority. This change has influenced accounting thought, practice, regulation, instruction, and research. Moreover, monopoly jurisdiction of accounting standards has made it increasingly difficult to experiment with alternative methods, slowing the discovery of better methods of accounting. The so-called “fair” value standard is a result of this process. Letting standards compete would promote the development of better financial reporting and the restoration of a balance between the role standards and social norms play in financial reporting.

KEYNOTE ADDRESS

There is a long tradition of an important role for social norms in financial reporting. Financial reporting evolved based on the judgment of

¹ Keynote address, Journée IFRS, Conservatoire National des Arts et Métiers (CNAM), Paris, September 14, 2007. S. Sunder, *Standards and Norms: Monopoly of Competitive Coexistence*.

businessmen and accountants. They collectively decided what the best practice in any given situation was and experimented with alternative ways of doing accounting. Depending on variations in economic environment and business structure, different accounting practices coexisted in most societies.

In recent decades, there has been a shift from social norms toward written national standards, and ultimately international standards. Induced by securities regulation, this transition is reflected in US accounting thought, practice, regulation, instruction, and research, and the same may happen in the EU with IFRS.

Increasingly, our thought processes about accounting are centered on what regulators and standard writers do. A large part of what is being written today in accounting books and research journals concerns the actions of standards setters. When the FASB issues a proposal or standard, researchers often conduct event studies on the consequences of regulatory action on the stock market. Accounting practice, too, has obviously been affected significantly by these standards.

The educational consequences have received less attention. Before accounting became standardized, members of a class could examine a transaction and discuss various ways in which it could be accounted for. Now, students memorize the rules promulgated by the FASB. Accounting education has shifted away from teaching students how to think about and analyze transactions and how to consider the economic consequences of alternative ways of treating transactions towards reading and understanding the rule book. The nature of the CPA exam—largely multiple choice—sends the message that questions in this profession have clear-cut right-or-wrong answers and only call for memorization. This message tends to attract weaker students to accounting classes and to the profession who are not necessarily interested in thinking for themselves about complex problems.

Today, accounting practice is no longer determined by general acceptance, but by a top-down process of enforcement by the Securities and Exchange Commission (SEC) in the US and by the European Commission (EC) in Europe. No longer is “generally accepted accounting principles” merely a description of generally accepted societal norms; instead the acronym GAAP is routinely applied to official promulgations. While standards are enforced by an authority with the power to punish, social norms are maintained by personal and social relationships and by internal and external sanctions. Social norms appear in all aspects of life from professional to national to familial. They are the shared (common knowledge) expectations of behavior, e.g., etiquette, dress, grammar, language, customary law, and private associations. While the accounting profession often looks to the legal profession as an example, it has paid little attention to the continued major role of social norms in law. Legal scholarship and practice 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 tends to leave the judgment in place. An example of this would be the concept of “reasonable doubt” as applied in criminal cases. There is no set of rules governing this and no set percentage of doubt that defines “reasonable”. Law does not attempt to codify answers to such questions. People who write and practice law understand all too well that clarifying such questions would lead to consequences even less desirable than the consequences of leaving the answers to the judgment, even of lay people. The objective of norms is observable behavior, not unobservable beliefs. In order for something to be a social norm, it must have a consensus, not just majority support. Dictionaries become respectable by attracting a following, not by enforced authority.

Let us take an example of an accounting norm: revenue recognition. It is an inherently subjective concept. We teach students not to recognize revenue until it has been earned, substantially all services necessary for this purpose have been rendered, and any remaining costs can be estimated with a reasonable degree of accuracy. Much judgment is necessary in applying this concept. A complete specification of conditions for revenue recognition to exclude judgment is both unnecessary and infeasible.

In today’s accounting discourse, with the allegiance of accountants shifted from norms to authoritative promulgation, standards have come to be viewed as a measure of progress (our rule book is thicker than yours!). Most research refers to standards with respect, if not approval. There has been little research and debate on the merits and consequences of standardization. William Baxter analyzed the corrosive effect of authority on the accounting profession half-a-century ago, but his ideas were largely ignored. Is it true that more rules make accounting better? I would argue that the opposite is more likely the case. Accountants can expect to be considered professionals as long as they, like physicians and lawyers, must use judgment to make decisions. Yet we seem to be intent on replacing the expertise and judgment of accountants with rules and thus diminishing accounting as a profession. As I mentioned earlier, there are limits to written standards. The SEC and the US Congress did not clarify the definition of insider trading beyond “trading on non-public information”. What constitutes “non-public information” is left open for interpretation and judgment. Suppose the SEC chose, instead, to make a rule that precisely defines “insider trading” as, say, “trading by directors and senior managers”.

Would that include trading by their spouses? What about sons and daughters, nieces and nephews, neighbors, cousins, and so on? It is easy to see that the greater the detail that is written in the rule, the worse it gets. The consequences of clarification are even less desirable than the consequences of leaving such matters open to judgment. This is just

what is happening in financial reporting. In an effort to clarify what is required, we have created corporate bodies like the FASB and the IASB to write rules. However, any body of law or rules that strives for clarity and enforceability must also avoid becoming a road map for evasion. As in the example of insider trading presented above, the clarification of a rule may just become a guideline for how to legally commit fraud. Under the current definition of insider trading, wrongdoers may wonder whether or not their actions are illegal; a more precise definition would make it easier for wrongdoers to evade the spirit of the law without violating the letter of the law and risking a conviction.

Another example of the consequences of clarification is financial instruments designed to get liabilities off the debtor's balance sheet. Bright line accounting standards, such as the 3 percent rule for special purpose entities, remove the uncertainty financial engineers would face in the absence of such standards. Thus, standard-writing agencies can become the unwitting accomplices of evaders.

There is also a fundamental weakness in the structure of a standard-setting body. A permanent rule-making bureaucracy must continue making rules in order to justify its ongoing budget and existence. If their sole job is to make rules, what else could we expect except that they will create more rules and, inevitably, the rulebook will get thicker over time. Until recently, the FASB was dependent on sale of its publications for a significant part of its revenue. The rule of "publish or perish" is as true in this situation as it is in academia.

Another consequence of having institutions with rule-making as their sole function is that their existence encourages requests for "clarifications." Auditors are asked 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 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. In this way, the existence of the FASB/IASB promotes an attitude of, "if it is not prohibited, it must be OK". 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 being redesigned to get around them and to frustrate the very purpose of accounting. The monopolies in the US and the EU deprive the 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

there is a better method. 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? This preference for uniformity stands in the way of the evolution of accounting, denying accountants the right to develop new and better methods.

As we have seen, there are a number of questions that can be raised about the wisdom of transitioning from a system of social norms, in which alternative methods compete, to a system of a unique set of standards. Perhaps the pendulum of standardization has swung too far. How can we find a balance between norms and standards in accounting? Accounting appears to mimic a poorly understood model of the role of social norms in law even as the growing popularity of stock and accounting based compensation for senior managers is putting them under greater pressure to try to manipulate accounting and auditing.

Consider “Fair” Value Accounting. First, this is an example of how important labels are. What do the following three have in common?: the Unified Budget Act of 1964 proposed by President Lyndon B. Johnson; the Patriot Act of 2002 proposed by President George W. Bush; and Fair Values proposed by the FASB and IASB in 1999. All involved “changes with deceptively reassuring titles”. These labels were chosen to put potential opponents on the defensive before the debates even began. This is an old device in the book of policy rhetoric. Johnson wanted to use Social Security surpluses to finance increased spending on Great Society programs and the Vietnam War and chose a label that challenged opponents to argue for a non-unified budget. Bush wanted to fight the War on Terror and chose a label that challenged opponents to argue against patriotism. The accounting standard setters want to use current values, but have chosen a label that makes opponents appear to be arguing against fairness. However, “fair” is a personal judgment, not a fact. To avoid this misuse of language, we should put the rhetoric of “fair” aside and once again use the label of “current” values, a concept that generations of accountants and researchers have thought and written about.

Current value accounting proposes the use of the price that would be received to sell an asset or that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is, of course, just one method of valuation in accounting. The debate over which valuation should be used in a given situation has a long history in accounting literature. Valuations were chosen based on their relevance to investment decisions, stewardship, management of enterprise resources, contract enforcement, and other criteria for evaluation, e.g., reliability, bias, timeliness, representational faithfulness, and cost of implementation. The debate surrounding valuation has been largely qualitative in nature, and without a framework for quantified

comparison, debates could go on forever. FASB has resurrected the debate under the new label after an interval of almost 70 years. Fortunately, we can use econometrics to bring an element of quantified rationality to this debate.

There are two primary sources of error in the valuation of a bundle of resources.

Price movement errors arise when the valuation rule ignores the change in values over time. *Measurement errors* occur in the current values used to revalue the bundle due to the imperfection and incompleteness of markets. The number of possible valuation rules is very large. Let us focus on the three most familiar elements of this subset – historical cost, current value, and general price level.

Historical valuation has price movement errors because it ignores changes in prices from the time of acquisition to present. The size of this error – mean squared error (MSE) – depends on parameters of the economy: the mean and the covariance matrix of the vector of relative price changes. The greater the “magnitude” of these two parameters, the greater the movement error associated with historical valuation. Since historical valuation ignores changes in prices, it is free of measurement errors. Current valuation has measurement errors arising from the assessment of current values. Again, the size of this error (MSE) depends on parameters of the economy. If we assume that the relative changes in current values are measured without bias, then the MSE arising from the mean of measurement errors would be zero. The error, then, arises from the covariance matrix of the vector of measurement errors in relative price changes. The greater the “magnitude” of this covariance matrix, the greater the measurement error associated with current valuation. Since current valuation takes into account the changes in prices, it is free of price movement errors.

General price level valuation (GPL) uses a single price index to adjust historical values towards current values. The use of a single price index reduces the price movement error associated with the historical estimator but does not eliminate it. The use of a single price index also introduces some measurement error, although it is not as large as the error associated with the current value estimator. The total error associated with GPL estimator depends on the values of the above mentioned parameters.

How good are these estimators of value? Which estimator is associated with a lower mean squared value? The answer entirely depends on the parameters of the economy. With high price volatility and low measurement errors, the current value estimator dominates. With low price volatility and high measurement errors, the GPL estimator, and perhaps even the historical value estimator, may dominate. In general, we should not expect that the MSE-minimizing estimator will be any of the three we have explicitly considered. Instead, it is likely to be some

intermediate price index specific estimator of value. Which valuation rule has $\min(\text{MSE})$ is a matter of econometrics, not theory or principle.

In light of the above discussion, it should be clear that current value accounting has its limitations. Current valuation is informative for firms and industries whose assets have a large mean rate of price change, have more variability in price changes, and are traded in relatively perfect and complete markets (accurately measured current value). However, it would not be appropriate for industries that have large measurement errors, such as real estate, mineral deposits, films, software, and patents. Instead of performing cross-sectional tests, we could benefit by paying more attention to the characteristics of the assets of firms and industries.

In summary, the pendulum appears to have swung too far in the direction of 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 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. Written standards could never capture either of these ideas. It may be necessary to create some kind of accounting court system to judge what constitutes "fair representation". We should assist the evolution of accounting norms by allowing competition among multiple accounting rule makers with no collusion or push for convergence. Instead of being forced to use the FASB's standards, what if US firms could choose to use FASB, IFRS, or another standards system? Standard-setting bodies could then receive their income solely from royalties charged for the use of their standards and have, their revenue based on how well their system actually works, not on how many rules they write. Once rule-making monopolies in the US, Europe, and elsewhere are removed and standards have to compete, we will have a healthier system of discovering better accounting systems and developing them over time, without eliminating judgment, and creating a better balance between standardization and norms.



Shyam Sunder is James L. Frank Professor of Accounting, Economics and Finance, at the Yale School of Management. Few aspects of accounting scholarship – whether mathematical modeling, econometrics, capital markets, managerial or international accounting, auditing, theory, history, standards, or policy – have remained untouched by him. He has brought fresh ideas to every accounting problem he worked on. His econometric analysis of the relationship between corporate accounting for inventory valuation (LIFO/FIFO) and stock prices helped found stock return as a measuring rod for how accounting choices may

affect the welfare of stockholders, pointing out not only the strengths but also the weaknesses of this research paradigm in his doctoral thesis written at Carnegie Mellon University (which received the American Accounting Association's Manuscript Award for young scholars). This thesis also developed new econometric techniques for testing for and estimating unstable model parameters.

In the mid-seventies, with inflation rising in U.S., he started his project on statistical modeling of valuation rules to integrate historical, general price level, specific price level, as well as current value accounting into a single framework, to enable scholars to see the statistical relationships of all these valuation methods in a unified framework. The final paper of this series showed that, in the presence of measurement errors, current valuation methods do not necessarily yield the most precise estimate of the true, underlying current value of a bundle of assets. His best known work, *Theory of Accounting and Control* (for which he received the second of his AICPA/AAA Notable Contributions to Accounting Literature Award) integrated accounting into the economic theory of organisations – if an organisation can be seen as an alliance among the interests of the suppliers of various factors of production, accounting and control can be seen as the operating mechanism of the alliance. This influential work, already translated from English into five languages, is used in many parts of the world to introduce a new perspective on accounting and governance to students as well as managers. While engaged in pioneering contributions to experimental economics since 1982, Sunder continues his interest in accounting through an analysis of regulation and standardisation of accounting and auditing, and alternative regimes for auditor liability. In his recent writings, he raises troubling questions about the consequences of the increasing importance of written rules at the expense of social norms of accounting.