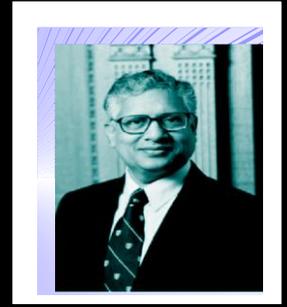


Interview with Professor Shyam Sunder Yale University



Professor Shyam Sunder is the James L. Frank Professor of Accounting, Economics, and Finance at the Yale School of Management; Professor in the Department of Economics, Yale University and Professor (Adjunct) at the Yale Law School.

“At some point, incentives to work harder are overtaken by the incentives to distort, manipulate and even cheat on measures of performance. Using powerful performance-based pay for executives, stock options included, is a questionable idea and deserves careful rethinking.”

Question: How does academic research in accounting benefit accountants and managers?

Answer: Research is a process of asking interesting questions whose answers we do not know, and would like to know. Research not only helps us find answers but also makes us aware of what we do not know. Surviving ideas filtered through discussion and debate, get into classroom, and ultimately into textbooks where accountants and managers learn about, use, and even benefit from them.

Question: Why are accountants and managers not interested in academic research in accounting?

Good academic research emphasizes new ideas. Only a few of the innovative ideas survive the test of time. A chemist may examine the properties of thousands of molecules before finding one that can be sold in pharmacies to treat some illness. The content of research journals is like unfiltered water; accountants and managers would take a great deal of risk in using it directly to guide their business decisions. A cancer patient who wants to try a new drug before it is properly tested takes much risk. So does a manager in relying on academic research unless he/she has the confidence in his/her own ability to judge the consequences of such reliance. Understandably, most professionals, like most patients, should wait until the new ideas prove themselves through the filters of field tests and experience.

Question: How can accounting research be made more relevant, useful and interesting to practitioners?

Answer: Paradoxically, the way to make our research more interesting to others is to make it more interesting to our personal selves. Unfortunately, a great deal of research is driven not by what the researcher finds interesting but by our beliefs about the prospects of its publication. Research motivated primarily by considerations of publication tends to follow the fads and fashions of the day and emphasize method instead of the question whose answers are sought. Ultimately, such research is self-defeating because it generates fewer new ideas, is difficult to publish, and does not interest the world outside academia. Instead, if researchers chose their topics because of their personal interest and curiosity, there would be a greater chance that others, too, especially among practitioners, may be interested in the answers to some of the questions researchers pursue.

Question: You have articulated the contracting perspective of accounting. How does it differ from the information perspective?

Answer: The contracting builds on the information perspective by looking at the interests, information, and the decisions of various people involved in organization. It views accounting as a mechanism to operate the organization in such a way that it serves the interests of various participants. It helps match the self-interest of participants with what others expect of them. Information is an essential ingredient in this environment, but there are also self-interest and contractual arrangements of many people. Contract

perspective does not favor one party over others, and considers them all together. It sees organization not as a purposive entity, but as an arena in which various participants seek their own satisfaction through interaction and exchange.

Question: You have been advocating a market-based choice between IFRS and US GAAP for US companies. What is the future of US GAAP after the SEC's decision to accept foreign issuers' IFRS statements without reconciliation to US GAAP?

Answer: Given the difficulty of choosing better methods of accounting *ex ante*, the opportunity to try out alternatives in the field is important. A monopoly regime, whether of the FASB in US or of the IASB in Europe and elsewhere, would close this window of opportunity with little compensating benefits. Further, teaching of accounting will turn to memorization of a fixed set of rules, and intellectually curious youth will not be attracted to such a profession. It would be more efficient for various governments in the world to allow two or more systems of accounting standards to compete for the royalties earned from companies who choose to report using alternative standards. Such competition would have the additional benefit of letting competing standard-setters learn from market feedback as well as from their own and the competitors' experience, leading to better financial reporting. Prof. Dye and I wrote about letting IFRS compete with FAS in the U.S. before IFRS was permitted there. I make a similar argument against granting a monopoly to IFRS in any part of the world.

Question: The financial community in the US (Wall Street) worries that the Sarbanes-Oxley (SOX) Act imposes excessive costs and this may be leading to London taking the place of New York as the leading destination for issuers. Is this concern justified?

Answer: We do not know. It is difficult to know the consequences of this (or any other) legislation in a short period of time before people have had the chance to adjust their behaviour to new circumstances. Consequences of SOX remain controversial and uncertain. As for London versus New York, the IPO transactions appear to be handled by the London or New York offices of the same investment bankers, and they direct transactions to the market in which they make more money. Finally, there is no virtue in more firms being public or private. The SOX Act does redefine the costs and benefits of being public or private, and it would take us a while before we can figure out its overall economic consequences. Some ten years later, it appears that most if not all those concerns about the dire consequences of SOX have turned out to be misplaced. Unfortunately, the same is true of most of the promises made about the benefits of SOX. Congress and regulators write the rules, the business community finds its way around them. You need more than written rules—some social norms and sense of right and wrong—to make a difference.

Question: What is your view of fair value accounting?

Answer: Fair value is a label consisting of a judgment instead of a description of a method of valuation. Such judgmental labels are unfortunate because they tend to prejudice the debate even before it starts. Who would want to argue for 'unfair' accounting? Therefore, it is better to use a neutral term such as current or market value accounting, of which we have learned a great deal through practice and research over the past century. As you would see from my article "Econometrics of Fair Values" and other work cited in that paper, properties of many important valuation rules can be quantified, examined and compared in a unified framework to assist policy decisions. Valuation rules can be viewed as econometric estimators. Which valuation rule has minimum mean squared error (relative to the unobserved economic value of bundles of resources) is a matter of econometrics, not of theory or principle; it depends on the relative magnitudes of the parameters—price volatility and measurement errors—in the economy, industry or firm. Analysis shows that, in general, no valuation rule, fair or not, dominates the others.

The financial crisis of 2007-2012 suggests that the so-called "fair value" accounting did not yield fair values, and had to be thought through again. This is one more piece of evidence about the difficulty of knowing the consequences of implementing newly-conceived methods of accounting without prior field experience, and against granting a world monopoly to any one standard setter.

Question: There is a view that quarterly reporting holds back managers from taking long-term decisions and promotes short-termism. How can we ensure that shareholders get timely information even while encouraging managers to take a long-term view of their business?

Answer: Like fair value, short-termism also belongs to the class of clever word-smithy that presumes to force an answer before the debate starts. Who would want to argue against farsighted behavior? Managers focus on short term because in an increasing number of cases, people who assess their performance

(including investors) focus on short term. If investors knew who the good managers are, the former could entrust the store to the latter, and let them run the show for a long period of time. In fact, not knowing how talented the manager is, investors try to evaluate him/her on the basis of measured performance before an incompetent manager does too much harm to the enterprise. Taking a long view, and thus delaying performance evaluation, increases the risk of failing to discipline or replace a poor manager. The same argument applies to institutional investors—the mutual fund managers—who evaluate corporate managers in the short run because they themselves are evaluated in the short run. In a world where we do not know the competence of individuals, we must trade off between short and long-term perspectives in organizations.

Question: How good are stock options in aligning managers' goals effectively with shareholders' interests?

Answer: Until only a few decades ago, most senior management of corporations were paid essentially a fixed salary, and worked hard to earn it. The idea of linking senior management compensation to measured performance was pushed by some academics and spread in practice. This idea has three fundamental weaknesses. First, it is unclear what a CEO is expected to do different when promised large amounts of compensation linked to the measured performance of the corporation. Aren't they supposed to work to the best of their abilities anyway? Or are they expected to hold back on their best efforts until promised money beyond their monthly salary? Second, the measured performance is for the organization as a whole, including not only the consequences of the efforts of the senior managers but also of others, and a large element of random chance beyond their control. Third, as large amounts of personal compensation of senior managers, who also control the strategic decisions and financial reporting of the firm, get linked to measured performance, incentives to distort their operating decisions, and manipulate accounting and stock markets rise. At some point, incentives to work harder are overtaken by the incentives to distort, manipulate and even cheat on measures of performance. Using powerful performance-based pay for executives, stock options included, is a questionable idea and deserves careful rethinking. Incidentally, it has been argued that the growth of stock options in the 1980s originated in government attempts to limit executive salaries in the first place.

Question: Do you see the rapid growth of private equity as a vote of no-confidence in public markets? Is this the beginning of the end of the public corporation as the dominant form of business organization?

Answer: No and No. Most businesses are not corporations, and most corporations are not public; they have never been, are unlikely to become public, and there would be little advantage to society if they were to become public. Growth of publicly traded corporation over the years was not a vote of no-confidence in non-public corporations. As circumstances of companies and the economy at large change, firms should be expected to choose among alternative forms of organization. It is an evolutionary process that is best left to work itself out through forces of the market.