

Accounting by Rules or Social Norms?

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January 2, 2015

- *Samuel Johnson published his dictionary not as the conqueror of the language but as the person who knew best how unconquerable it really is.*

Verlyn Klinkenborg (2005)

- *The rules of accounting, even more than those of law, are the product of experience rather than logic.*

George O. May (1943)

- *Common global standards, if read to mean identical, is an illusory and unobtainable goal. However, seeking to achieve similar objectives and to address in an effective way similar problems is a realistic goal.*

Richard Breeden (1992), Former Chair, U.S. Securities and Exchange Commission

An Overview

- Why such widespread accounting abuses?
- Short, medium and long-term perspectives
- Accounting by norms or design
- Regulation and the age of standards
- Evidence for other social phenomena
- Failures of markets, and of regulation
- Living with financial engineers: standards as road maps for evasion
- What could we do?

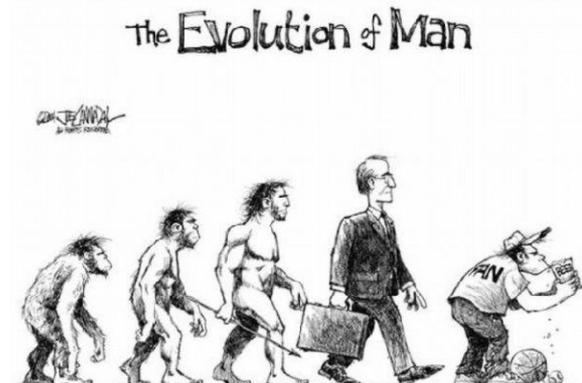
Idea of Intelligent Design

- That complex social or biological systems can be DESIGNED by conscious intelligent entities
- That they have the ability and wisdom to define the ends, and design to attain these ends efficiently
- That they are, or should be, invested with the power to enforce their design on others
- Where does this entity reside?

Emergence or Evolution

- Darwin: Complex biological systems evolve over time through mutation and natural selection in their environment
- Evolution has no goals or direction of advancement (except time)
- Evolution does not guarantee efficiency
- The resultant “designs” encapsulate enormous amount of information
- Outcome: design without designer

(c) Shyam Sunder: Norms and Rules



Emergence

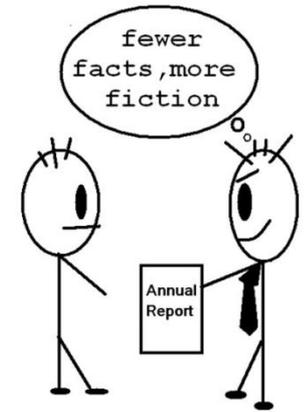
- Friedrich A. Hayek: social systems emerge through simple interactions among individuals
- Preferences and information is inherently dispersed among individuals, and no central authority can have access to this information to achieve efficient central planning, even if it were feasible to do so computationally
- Markets are able to aggregate the preferences and information in possession of millions of individuals
- Organization, like language emerges through interactions among micro-units



US Corporate Financial Reporting: Design Perspective Dominates for 80-Years

- U.S. project to standardize accounting since the 1930s
- Eight decades of standards as the solution: today they dominate accounting thought, practice, regulation, instruction, and research
- Generally accepted accounting principles—no longer a mere description in its plain English meaning of a generally accepted societal norm
- Capitalized into a proper name—**Generally Accepted Accounting Principles**
- **GAAP** as rules issued by authority with power to punish nonconformance
- How and why did written standards replaced norms and responsibility?
- What are the consequences of this transformation?
- Alternative courses for accounting and corporate governance?
- Reliance on written standards rooted in a misunderstanding of legal reasoning
- Chasing objectivity without personal responsibility
- Law, family, neighborhood, drug and alcohol abuse, workplace, dress, table manners, language, and sports—all balance social norms and written standards
- Re-establishing this balance in accounting and corporate governance may help
- Thinking in and out of the accounting box
 - Are written standards a solution to our problems, or a problem?

Accounting Abuses



- U.S. Accounting abuses and their consequences
- Response: overhaul of accounting and auditing regimes
 - Written accounting standards (FASB, IASB)
 - Sarbanes-Oxley (SOX) Act 2002: Additional powers to the Securities and Exchange Commission (SEC)
 - Additional requirements on the certification of internal controls
 - Public Company Accounting Oversight Board (PCAOB) to oversee audits of public firms, write auditing rules, and to monitor audit firms and the industry
 - Effectiveness of these measures is open to question
- Diagnose the problem: short and medium-term issues, and then the longer term issues

A Short-Term Perspective

- The immediate causes of failures: beliefs of executives, auditors, lawyers, investment and commercial bankers, and corporate directors that they could default on their duties without bearing the consequences
 - Compounded by the failure of government to discipline the individual failures
- Cases wound their way through the courts
- Will enforcement of the existing laws remedy the problem?
- Mixed signs:
 - Enron's auditor is out of business but its law firm is not
 - Qualified people reluctant to serve as the directors; nominating committees reluctant to choose technically qualified but unknown people for boards (why should they pick strangers?)
 - More non-employees on audit and compensation committees; but unclear if they serve the interests of others any better (field study of engagement)
 - Rapid rise in the compensation of senior executives continues; back-dating scandal
 - Stiff resistance to Dodd-Frank Act from business and Wall Street

Medium-Term Perspective

- Two critical events of the recent decades
 - U.S. government decided to push competition in the audit industry in 1979 (Sunder 2003)
 - Rise in performance-contingent compensation for senior corporate executives
- Policies driven by the dominant economic theories of the moment
 - Competition was also supported by the U.S. Supreme Court through its decisions (e.g., Bates vs. Bar of the State of Arizona)
- The general theory (competition promotes economic efficiency) applied to audit industry created a textbook example of a “market for lemons”
- Price and quality of audit services declined in the early eighties
- Audit firms try to find alternative sources of revenue (consulting)
- Audit services became loss leaders for consulting/advisory services
- Fall in prices and the quality of audit services, combined with the increased executive temptation to commit accounting fraud
- Consequences of this combination were played out over two decades until a sharp drop in the economy and the stock market, following the dotcom bust, brought the house down

Longer-Term Perspective

- Over a century, another pattern emerges
- Since the enactment of the securities laws in the early 1930s, the U.S. has seen a steady shift in financial reporting
 - From business and professional norms towards legislated written standards enforced by threats of explicit punishment for violators
- This shift altered virtually all aspects of accounting (including accounting education)
- The recent events can be seen as a consequence of the policy decisions of the past eight decades.

Accounting by Norms



- The early twentieth century predominance of norms
- The charge the American Association of Public Accountants gave to a Special Committee on Accounting Terminology in April 1909
 - to collate and arrange accounting words and phrases and show in connection with each the varying usages to which they are put. ... This committee will not attempt to determine the correct or even the preferable usage where more than one is in existence (Zeff 1971, p. 112).
- In 1918, a memorandum on auditing procedures, prepared by the American Institute of Accountants, and approved by the Federal Trade Commission (FTC), and originally published in the *Federal Reserve Bulletin*, labeled “A Tentative Proposal Submitted by the Federal Reserve Board for the Consideration of Banks, Bankers, and Banking Associations; Merchants, Manufacturers, and Associations of Manufacturers; Auditors, Accountants, and Associations of Accountants.”
- The intent was to coordinate the evolution of norms, and not to impose and enforce a standard.

Facilitating Evolution of Norms

- In 1918, the American Institute of Accountants appointed a Special Committee on Interest in Relation to Cost to address a lively controversy on imputed interest as part of the cost of production
- The Committee's recommendation against inclusion of imputed interest in cost of production, approved at the annual meeting of the Institute, does not become accepted as an accounting norm
- The Institute appoints a special committee on the standardization of accounting procedure "to consider all questions of procedure brought before it, and to make recommendations from time to time on vexed questions in the hope that ultimately there may be established something approaching uniformity of procedure throughout the country"
- The charge suggests facilitation to form norms, not legislation of standards. During its eleven-year tenure (1918-1929), the Committee produced six reports, and none was submitted for an official stamp of approval of the Institute's membership

Norms as an Attitude

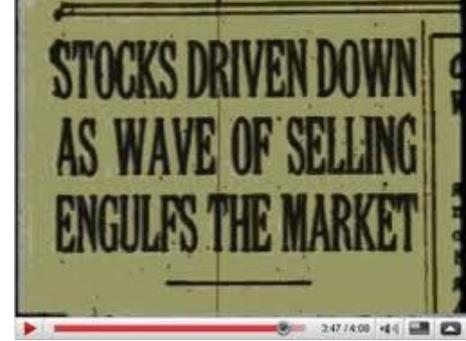
- The absence of authoritative standards of accounting did not mean that the world of accounting had less order in the early twentieth century than in the early twenty-first
- Active mechanisms the accountants used to identify the norms of their profession
 - *Journal of Accountancy* and the *CPA Journal* served as forums for active, even feisty debates on accounting and auditing; a function largely abandoned by the professional accounting journals over the past quarter century when authoritative standards pushed the norms out
 - During 1920-29, the Librarian of the Institute issued 33 “special bulletins” on topics referred to them, without the authority of the Institute.
 - In 1931, the Institute published a 126-page book *Accounting Terminology*, a compilation of accounting terms and their definitions as a matter of advice, not authority.
 - (See Kitchen’s (1954) *Costing Terminology*, a cogent argument for resisting the temptation to issue authoritative definitions, especially in accounting)
 - Throughout the 1920s and into 1930s, a committee of the Institute worked in close cooperation with a committee of Robert Morris Associates, an organization of bank loan officers, to respond to inquiries submitted to them.



Example of an Accounting Norm

- Revenue recognition: do not recognize until earned
- Inherently subjective
- Complete specification of conditions both unnecessary as well as infeasible
- No authoritative source
- Everybody is free to propose their own norm; they may or may not be accepted
- Authority derives from general acceptance by the financial community and disapproval of deviations

Norms Not Enough: An Era Ends



- Role of fair value accounting in the “roaring twenties” (surprise, it is back again!)
- The stock market crash of 1929
- Severe economic depression that followed, precipitated another crash
- Loss of credibility of norms of accounting, and the formal or informal mechanisms by which these norms evolved and were sustained
- Too many had lost wealth, livelihoods, even lives
- Financial reporting transgressions were far too many, people lost trust in the social contract
- It was time to identify and punish—at least constrain—the guilty
- Politicians responded the only way they could and introduced federal securities laws and regulations (to override the states)
- In the following seven decades, accounting and audit failures have been interpreted as evidence that norms do not work;
- Norms were gradually shifted to the back burner, and legislated accounting standards gradually rose to dominate corporate financial reporting
- Have the standards achieved, and can they achieve, their purported goal?

Federal Securities Regulation

- In 1933-34, U.S. Congress give SEC the legal authority to regulate financial reporting
- The first three decades: mostly codified the existing practices
- Gradually, these efforts shifted from identification of conventions or social norms to promulgation of standards with increasing power of enforcement
- Increasingly assertive nomenclature of the three private sector organizations to write accounting rules
 - The Committee on Accounting Procedure's Accounting Research Bulletins (1948-59)
 - The Accounting Principles Board's Opinions (1959-73)
 - The FASB's Financial Accounting Standards (1973 to present). (IASB's International Financial Reporting Standards being the latest addition to this trend)
- By 2000, the social norms have few advocates left, most favor legislated standards (with legal enforcement) model for financial reporting
- Yet, the evidence that formal standards do any better than social norms of financial reporting remains elusive
- The case for the efficacy of enforced standards remains to be made
- In the absence of evidence, should the benefit of doubt go to the government or the market?
- Thoreau's motto: "that government is best which governs least."

RULES

1. YOU CAN....
2. YOU CAN'T...
3. YOU CAN...
4. YOU CAN'T

Standards as Progress



- Accountants shifted their allegiance from norms to authoritative promulgation
- Profession now views standardization as a measure of progress (our rule book is thicker than yours!)
- Most research refers to standards with respect, if not approval
 - “By the outset of the 1970s, an energetic and ambitious plan was in operation.” Zeff on standardization attempts of the English Institute in Lectures on Forging Accounting Principles in Five Countries
- Baxter analyzed the corrosive effect of authority on accounting profession half-a-century ago
- Those ideas were largely ignored
- There has been little research and debate on merits and consequences of standardization in accounting

Appeal of Standards

- Easy to identify the history of accounting with the organized efforts to produce written rules
- Such efforts leave documentary traces for historians, norms don't leave much even if they are widely accepted, leave nary a footprint, except in fiction
 - E.g., Lisa Evan's papers on textual analysis of novels with respect to accounting and social norms during 1923's German hyperinflation

Appeal of Standards

- Written standards: concrete, salient, published, easily disseminated, easy to find, specified formally with some precision, can be analyzed and discussed line and verse
- They come into existence at a specific time, through a known and understood institutional process that may allow the participation of the constituents
- When the environment changes, a systematic process is available to formulate changes and submit them to a well-specified process for possible promulgation
- Democratic appeal of a transparent institutional mechanism for setting standards
- Following accidents and scandals, “the rules were not clear” is a popular defense
- Let us make the rules clear to all—as a response to calm the political waters
- Even George O. May, an influential leader of profession and an ardent supporter of norms, responded to William Ripley’s “Stop, Look and Listen” (1926) by a call for clearer definition of authority
- Formal written standards appeal to our sense of good housekeeping
- Specified processes for enforcement of violations



Norms Are Messy

- Social conventions and norms are rarely well defined, vary in time and space, require an extended socialization process to learn and understand (Coleman [1990])
- They carry a penumbra of uncertainty about them
- Substantial but incomplete overlap among the beliefs of the individual members of a group about its norms
- Norms evolve in small, almost imperceptible steps, by processes that are not well understood
- This evolution is decentralized, difficult to predict the future direction
- While the evolutionary process is not opaque, the lack of definition and our poor understanding of how norms evolve make them less transparent
- Scandals mock the claims of expertise and efficiency required to legitimize existing institutions
- During periods of crises, political or bureaucratic decision makers feel pressured to write new standards rather than continue to rely on existing (recently discredited) norms and business practices





What About Enforcement

- Formal standards call for formal enforcement
- Government departments, courts, regulatory agencies, industry associations, and private sector bureaucracies in national and international domains have a stake
- Formal enforcement of informal social conventions is difficult, no assurance of enforcement
- Word-of-mouth mechanisms in business relationships provide feedback; damage or enhance reputation (cotton and diamond trades, even e-commerce), but don't always do so
- Yet, social norms do work, nationally and internationally
- The human rights movement, even the U.S. yielded recently to evolving international norms on the death penalty for minor and mentally retarded offenders
- The Texas state anti-sodomy law struck down; the Court cited “values shared with a wider civilization...European Court of Human Rights, and other nations...”
- Standards: apparent advantages of clarity, explicitness, and the power of enforcement; but also disadvantages relative to evolutionary social norms

Failures of Market and Regulation

- Regulation often proposed as a solution in case of market failure
- However, regulation, too, is subject to failure (see Djankov [2003]).
- Consider four possible reasons why formal standards and their enforcement, with all their apparent advantages, may not dominate social norms in financial reporting
 - The information problem
 - The design problem
 - The gaming problem
 - The signaling problem

1. The Information Problem



- Rule makers' problem: How to figure which rule is better
- What is a good rule for determining interference in soccer? What is a good height of the goal posts?
- Each possible answer changes the game itself
- Accounting rules affect many members of society in diverse ways
- The direct effect of the rules on people depends on their individual circumstances that the rule maker knows little about
- Rules are designed in the hope that they will change or constrain the behavior of at least some people
- Changes in the behavior of individuals interact in complex ways to generate aggregate consequences that are difficult to anticipate
- The rule maker may try to ameliorate this informational disadvantage by soliciting information from the parties potentially affected by its actions.
- No incentive to report truthfully; strategic responses only muddy the waters (Sunder [1997], Chapter 11, [[2003]], create the gaming problem discussed below, often forcing the rule maker to deal with unintended consequences of the rules.
- Information disadvantage of rule-making monopolies

Evolution Incorporates Much Information

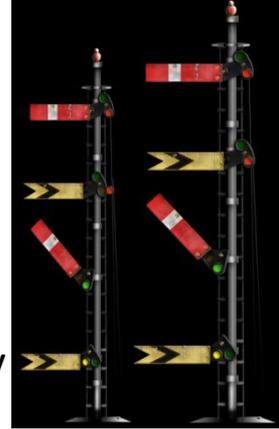
- In social conventions, as in biology, evolution proceeds in fits and starts, with no assurance of progress
- Each small or large change in conventions is induced by, and induces changes in, individual behavior
- With each change, the social system to a new, albeit temporary, equilibrium in expectations (see Sunder [2002])
- People get the chance to experience the consequences of each change, and adjust their behavior to the new circumstances
- Information in possession of the individuals aggregated into these outcomes through market and other social processes (Hayek 1945)
- Evolved social norms tend to incorporate more information than the rules made by legislature, boards, and other corporate entities.

3. The Gaming Problem



- The information problem compounded by dynamics between rules and the behavior the rules are intended to influence
- Each standard alters the decision environments of individuals, and potentially alters their decisions
- Induces individuals to search for new alternatives, create new opportunities
- The rule makers cannot anticipate all such changes
- Therefore, the new rules often lead to unintended consequences
- Adjustment of rules sets up yet another cycle of new behavior and adjustments
- Individuals can adjust faster than the rule makers can
- Difficult to make sure that this action-reaction sequence converges to a rule and behavior in equilibrium
- Informality and the flexibility of social norms can better deal with this gaming problem
- Evolution is stretched over a long period of time, and may get stuck in a rut (e.g., Scapens' monkeys with bananas)

4. The Signaling Problem



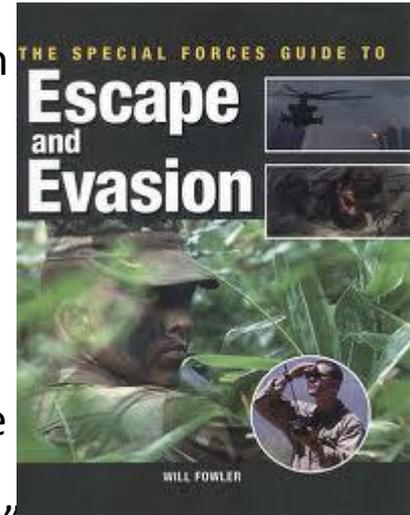
- The standards favor narrowing the range of options for the reporting entity
- Intention: promote comparability and consistency, and information value
- The argument ignores the signaling value of the choices made by the reporting entity
- In choosing from a given set of alternatives, one reveals private information
- Managers reveal their privately held information, in part; through the financial reporting methods they choose (Dye, Levine)
- The use of aggressive or conservative accounting gives away valuable information to careful readers of the financial reports
- Narrowing financial reporting choices through strict standards also eliminates the ability of managers to signal information through their choice of financial reporting methods
- The information, design, gaming and signaling problems are ever-present in setting standards
- They deserve consideration when we weigh the roles of standards and norms in financial reporting

Limits of Written Standards

- Legal scholarship and practice is careful in recognizing 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 leaves the judgment in place
- When a judge asks the jury to determine if the accused is guilty beyond reasonable doubt, lay jurors would want to know how much doubt is reasonable: ten percent, two percent, or one percent?
- Law does not attempt to codify answers to such questions
- People who write and practice law understand all too well the consequences of clarifying such questions would be even less desirable than the consequences of leaving the answers to the best judgment, even of lay people
- The SEC and the U.S. Congress refuse to clarify the definition of insider trading beyond “trading on non-public information”
- Again, the consequences of writing “clear” rules can be even less desirable than the consequences of leaving such matters to judgment.

Drawing Road Maps for Evasion

- Unfortunately, accountants are willing to pursue endless clarification of rules to the point of defining the percentages that justify
 - Materiality
 - Lease capitalization
 - Consolidation
 - Non-consolidation of special purpose entities, etc.
- With such written standards it is child's play for the Wall Street bankers, accountants, and lawyers to design transactions to frustrate the intent of the standards
- Without intending to, standard setters draw “road maps for evasion”
- The Wall Street (and perhaps the City) loves it; but fair reporting gets lost
- Setting up accounting institutions such as the FASB and the IASB, whose sole function is to issue new accounting rules, has contributed to the tendency to write standards which are “generally accepted” only by fiat of authority. They must make new rules to stay in business.
- Wisdom from law, abolish the rule making monopolies in various jurisdictions, and introduce competition among rule makers with each financial reporting jurisdiction in order to address this problem (Dye and Sunder 2001, Sunder 2002).



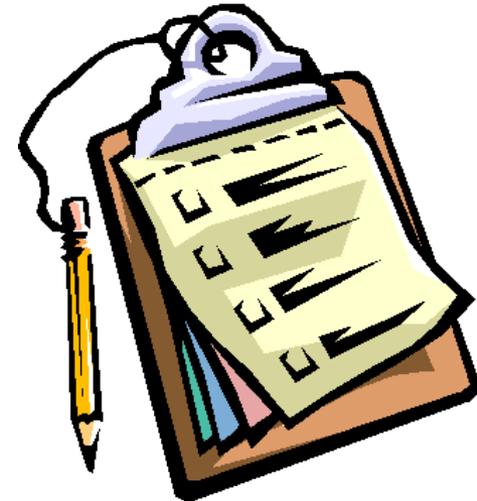
Cohabitation of Financial Reporting and Engineering



- Investment banker calls the FASB
- Financial engineering to get around the rules
- A reasonable body of rules might be devised to deal with a given set of transactions
- No rules can be devised when transactions are continually redesigned to get around a slowly adapting body of rules
- Minimal changes to get over the bar
- Wall Street calls to FASB/IASB can have the character of the thief asking when you plan to be away from home
- Financial reporting has no defenses against financial engineering

An Agenda for Reforms

- The pendulum seems to have swung too far in the direction of written standards
- Reconsider a stronger role of social norms and personal and professional responsibility in accounting and business
 - Rethink performance-contingent executive compensation
 - Transfer control of accounting system
 - Reconsider virtues of promoting competition among auditors (a “market for lemons”)
 - Better use of social norms: “true and fair representation” as a moral compass of accounting
 - As “guilty beyond reasonable doubt” in criminal law
 - Neither can be captured in written standards
 - Creation of accounting courts to judge “fairly represent” (Spacek)
 - Assist evolution of accounting norms through competition among multiple accounting rule makers (no collusion, no convergence, not “intelligent” design)
 - Remove rule-making monopolies in U.S., Europe (and elsewhere)
 - Remove mandatory audit
 - Single accounting treatment for tax and financial reporting



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