

Why Reconsider the Top-Down Push for Uniform Financial Reporting Standards

Shyam Sunder

Yale School of Management

Presented at the 29th Congress of the European Accounting Association
Dublin, Ireland, March 22-24, 2006; Opening Plenary Session: KPMG Symposium on
International Accounting Regulation and IFRS: Implementation in Europe and Beyond.

Shyam Sunder is James L. Frank Professor of Accounting, Economics and Finance at
Yale School of Management, and President-Elect of the American Accounting
Association. The views expressed here are his own. Email: shyam.sunder@yale.edu;
Website: www.som.yale.edu/faculty/sunder.

Why Reconsider the Top-Down Push for Uniform Financial Reporting Standards

Shyam Sunder

Yale School of Management

I am grateful to you, Professor Giner, to President Olov Olson, Professor Aileen Pierce, and the Organizing Committee of the European Accounting Association Congress for this opportunity to speak this afternoon.

Arguments for developing and enforcing uniform international standards for financial reporting have been articulated eloquently and with great wit by Sir David and other distinguished colleagues, here today, and elsewhere.

The European Union and many other countries are well on their way to adopt, implement and enforce the IFRS. Indeed, the question on the table today is not the desirability of uniform world-wide standards, but how we might implement them.

The core arguments for setting forth uniform standards are:

1. They serve as a coordinating device, saving time and effort, just as the rules of the road speed up traffic, and reduce accidents.
2. Public policy should be made through a well-defined, transparent, process with clear outcomes.
3. They make auditing easier, and are useful to auditors in their negotiations with their clients.

I believe these are valid arguments.

However, I also believe that public policy should not be made on the basis of the pro-case alone. We should also consider the con case, and then decide by the balance of weight between the two cases.

The benefits of uniform standards are clear, concrete, and immediate. My arguments on the other side are diffuse, hypothetical, and their consequences lie mostly in the future. It is easy to ignore the hypothetical in favor of the concrete. Yet, many of us often conclude, and teach, that hypothetical opportunity costs are a better basis for making decisions than concrete historical costs.

In these fifteen minutes, please allow me to outline six arguments of the con-case on enforcing uniform financial reporting standards by the power of authority. There isn't time to mention other arguments, or to go into details.

At the end of these remarks, I shall propose a system of supervised competition among multiple sets of standards written by independent bodies such as IASB, FASB, or by accounting firms. As investors, companies and auditors could then choose from a set of competing standards. It is possible that, through market competition one set of standards wins out over the others, or several sets may coexist, each attracting its own clientele, without the enforcement by the state. This bottoms-up alternative to standards monopoly offers many advantages. Let me explain why.

First, accounting being the language of business, we know that the usefulness of words arises from the uncertainty—the penumbra of variations of meanings—associated with words. Value of any word—“cat” or “house” or “assets”—would be lost if they could only be used for exactly identical objects. “House,” for example, is a general concept, referring to a variety of existing and not-yet-conceived-of constructions. Whether the word “house” is to be used for a particular construction must necessarily remain a matter of judgment of speakers. This centrality of judgment and variation in usage is the essence of all natural languages. When we clean the language of the ambiguity and variation in meaning, we get something like Esperanto—dead on arrival.

The value of the Oxford English Dictionary arises from encyclopedic collection of the various ways in which a word has been used, not in recommending, nor enforcing its opinion. Variability and dynamics of meaning is the source of vitality of a language. The power of English derives, not from authority, but from the freedom it permits us to communicate. Many natural languages have been, and some continue to be, strangled by the over-jealous advocates of their purity, determined to force uniformity of usage. No language, accounting included, can flourish under the protective umbrella of punitive authority of state.

Second, accounting is a part of complex social phenomena. The tendency to set standards enforceable through the punitive power of the state is rooted in the Cartesian world view. This perspective presumes that we have enough rational understanding of the world and enough knowledge of designing social structures to achieve the desired ends. There is no evidence, especially in accounting, that our existing or potential knowledge justifies this Cartesian view of the world of business and accounting.

As an alternative to this command-and-control perspective, consider a Darwinian world where complex phenomena emerge through unpredictable events and their poorly-understood interactions. Hayek pointed out that the information in our economy is inherently dispersed. It is not possible for any centralized authority—no matter how wise and benign their intent—to know and design social or biological systems to attain specified goals.

After a quarter century of being ignored, Hayek’s perspective proved to be right, and the debate on the ineffectiveness of central planning was settled. By trying to standardize accounting from the top, using command-and-control, must accounting refuse to learn from the mistakes of central planning? Must we lose another hundred years in making mistakes we can call our own, before we learn?

Third, the design of social systems is far more complex than of physical systems because the elements of social design—us, the sentient beings—react to the choices and adjust their behavior. People affected by standards take little time to adjust their behavior and redesign their transactions to get around the intent of the slow-moving standard setters. This dynamic game between economic agents and standard setters is a losing battle for the latter. It is like me sitting in a wheelchair playing tennis against Maria Sharapova (not that it will help much if I was on my feet).

Written standards have been of great value in physical systems, such as computer operating systems and Internet protocol. Yet, absent competition between Apple and IBM PCs, we would still be running DOS of the early eighties.

Fourth, information has interesting qualities. Standard setters may think that they can make users better off by reducing the number of permissible accounting alternatives. But, by making choices, we reveal our secrets; the fewer the permissible accounting choices, the less revealing are our choices. A firm that chooses the accelerated over the straight-line method of depreciation reveals the confidence of its managers in the future of the firm. How else could it credibly reveal such information to investors? The uniformity dogma in financial reporting ignores the signaling value of choices people make.

Fifth, the standards degrade education and training of accountants through their corrosive effect on textbooks, curricula, examinations, and the classroom discourse? They have shifted the focus of accounting education from preparing professionals to think about the best way to deal with any given event or transaction, to what the rule book says. Can we attract talented youth to study a discipline that consists largely of memorizing a fixed set of rules? The power to think is discounted once alternatives to the official creed enshrined in the written standards have been declared out of bounds by authority.

Finally, we should consider the effect of standards on the attitudes of corporate managers and auditors. Standardization is the opposite of making difficult judgments after considering the relevant facts. Standards provide a cover from having to take personal responsibility for one's judgments. The scandals of the recent years have made it clear that thirty years of intensive pursuit of the "gold standard" of accounting revealed it to be fool's gold; the chase of the dream of uniform accounting revealed it to be a mirage.

Over the past seven decades, standards have progressively become substitutes for social norms. Instead, they often serve as road maps for evasion. Rules versus principles is a misleading debate; given the time and budget the FASB has had, I would not be surprised if the IASB's rule book twenty years from now could become just as thick, if not thicker. Their processes are similar and so will be their outcomes.

Few aspects of our lives exclude social norms, and depend so exclusively on written standards as the accountants are attempting to do. No other learned profession relies on standards as accountants are being asked to do. Not doctors, not lawyers, not dentists, nor actuaries. Judgment, not written standard, is the essence of a learned profession. If we do

not stop chasing the mirage of uniformity and comparability now, we may soon destroy our profession and any value society places on our services.

Even if you agree with my arguments, you may want to ask me two questions:

What do I suggest we do?

Isn't it too late to stop the speeding train of standardization of financial reporting?

As to the first question, I do not suggest a free-for-all in accounting. Both Kitchen and Baxter argued, not against standards and definitions, but merely against those written by authority. I agree with them.

Take away the power of authority of the SEC that stands behind the FASB, and the power of EU and an increasingly number of other governments that stands behind the IASB.

In each jurisdiction, authority could choose at least two, perhaps three or four, bodies whose standards would be acceptable. Every company in the jurisdiction would be allowed to choose the set of standards it wishes to follow. These bodies would be financed exclusively by the royalties they collect from the firms which use their standards. The standard setters would effectively compete with each other for these royalty fees, and would be forced to make difficult choices which might, possibly, reduce the cost of capital of the companies that use their standards. OED competes with other dictionaries; so could the accounting standard setters.

Convergence may or may not emerge out of this bottoms-up competition, and is not important. Such competition occurs in many regulatory fields including stock exchanges, university accreditation, certification of ships and appliances, etc. There is no evidence that competition would lead to a race to the bottom.

Isn't this late in the day to try to stop this speeding train of standardization in financial accounting? I suggest that it is never too late for us academics to think and share our analyses. And it is never too late to reverse policy if we are convinced that it is not in our best interest.

Moreover, much of what I have to say today was written, more beautifully than I can express, by two great thinkers of accounting in the early fifties. One was late Professor Kitchen, in his article "Costing Terminology" and the other, Professor William Baxter of the London School of Economics in his article on "Recommendations on Accounting Theory" Half-a-century later these two are still the two best analyses of accounting standards.

In the true spirit of open debate on matters of public policy, I realize that in your judgment the pro-case we have heard over the recent decades from the distinguished proponents of uniform, enforced standards may dominate my con-case.

I only request that you withhold judgment until we have developed, heard, and weighed both sides of the argument, before deciding. I have presented similar arguments to the SEC and the FASB in the US.

Lest these remarks be regarded as an attack on IFRS, FAS, or their creators, allow me to quote from William Baxter:

We thus have cause to be grateful to the drafters of recommendations; and this review should on no account be construed as an attack on them. Obviously, they have devoted much time and care to their task, and have been prompted by a high sense of public service. If harm should in the end come from their work, the blame should attach more to their disciples who have accepted their teaching too eagerly, and have invested it with an *ex cathedra* quality that could not perhaps been foreseen.

It is not unusual in human affairs for a thing to be started with the best intentions, and yet to develop aspects that threaten harm. My plea is that we should now review the good and bad alike, and see whether we cannot guide future growth in directions that are wholly good.”

Those words were written in 1953. Perhaps it is time the debate begins. Thank you.

Why Reconsider the Top-Down Push for Uniform Financial Reporting Standards?

Shyam Sunder

Yale School of Management

KPMG Symposium on International Accounting
Regulation and IFRS: Implementation in Europe
and Beyond

29th European Accounting Association Congress,
Dublin, Ireland, March 22-24, 2006

Why Reconsider

- Uncertainty and dynamic and cross sectional variation in meanings attached to words is the essence of any language—the same is true of accounting
- Cartesian top-down, design, command-and-control, central planning perspective vs. Darwinian-Hayekian evolution and emergence from markets and social processes perspective
- Impossibility of stable social systems
- Uniformity dogma ignores signalling value of choice
- Degradation of education and training, unattractiveness to talented youth
- Standards as alternatives to social norms and personal responsibility to become road maps for evasion

What Could We Do?

- Each jurisdiction permits two or more competing sets of standards, no monopoly
- Each company decides which standards to use in its reports (investors react to choice)
- Standard setting financed by royalties collected from companies using their standards, and compete for royalties
- Forced to make difficult choices in the hope of identifying better standards through market feedback
- Convergence may or may not occur in this bottoms-up approach driven by market

Shyam.sunder@yale.edu

www.som.yale.edu/faculty/sunder