Introduce Regulatory Competition to Simplify Financial Reporting

Shyam Sunder

Good financial reporting is important for efficient corporate governance, capital markets, and the economy. However, what is good, and how to set up a system to develop good reporting, remains unclear.

Under oversight and enforcement power of the Securities and Exchange Commission, the Financial Accounting Standards Board has led the way for the past 34 years in writing accounting rules. While their approach has been imitated in many parts of the world, their leadership is now threatened. Governments in rapidly developing capital markets outside US tend to prefer their national and “international” rules for their companies.

New rules induce corporations and bankers to respond by devising new transactions and instruments, which call for newer rules. This vicious cycle has produced a complex corpus of some 159 standards and scores of other documents so far. The ubiquity of the financial reporting abuses of the recent years raises doubts about the efficacy of this approach to improving financial reporting.

Two changes can help to place bounds on complexity and develop and implement better and simpler accounting. One is to restore a balance between the roles of social norms and written rules in accounting. Second is to introduce some regulatory competition by permitting companies to choose from two or more sets of financial reporting rules. Such changes will yield the extra dividend of promoting the innovativeness, efficiency, reputation and attractiveness of US capital markets in the world.

Until the passage of federal securities laws in the 1930s, financial reports were governed by a system of social norms in business and accounting community. There were few written rules outside the regulated industries. Accounting methods were actively debated in professional forums and classrooms to hone accountants’ judgments for which they bore personal responsibility.

Since the 1930s, social norms and professional judgment have been gradually replaced by written rules and their enforcement by threat of punishment. The truth and fairness of the financial big-picture of companies often gets lost in compliance with a complex set of written rules. A finer sieve has more holes.

Social norms and precedent are important in common law; the written words in statutes, a delicate balance between the two kinds of law defines the nature of our society. After lawyers present the evidence and their arguments, lay jurors decide on the guilt of the accused. Society could not abandon common in favor of statutory law without careful weighing of its consequences. Yet, over the past seven decades, the Securities and Exchange Commission has abandoned social norms in favor of written rules of accounting with little analysis and debate.

1 Based on address to the Board of Trustees of the Financial Accounting Foundation in New York on February 26, 2007.
Creation of a full time rule-writing body encourages auditors and their clients to demand endless “clarifications” of rules, even as bankers devise new derivatives to defeat their intent. The amount of detail in the rulebook is the function of time, not of the rulewriter’s intent. With growth of written rules, lively classroom discussions are replaced by dreary memorization. The brighter students prefer intellectually exciting majors, and the quality of human talent in the accounting profession takes the hit.

Since the problem lies in the structure of rule making, so does the solution. Everpresent pressure for “clarification” of rules needs a countervailing force. Making alternative sets of written rules compete for allegiance of companies and their investors can introduce this balancing force. It will help place bounds on complexity of rules of financial reporting, with the additional benefit of market feedback into the rule-making process.

Under a system of competitive standards, the Securities and Exchange Commission in US (and the EC in the European Union as well as other appropriate regulatory bodies in various parts of the world) could choose and approve two or more standard-writing organizations for their respective jurisdictions. They would permit each public company in their jurisdiction to freely choose one of the approved sets of financial reporting standards for the purpose of preparing its financial reports.

SEC, for example, could allow FASB and IASB’s standards to compete in the US as a start, with the possibility of letting others enter the field after some experience with the competitive regime. The EC in the European Union could similarly permit the standards written by these two organizations and, in addition, let companies that so choose, to report using their respective national standards (e.g. British or German standards) as a third choice. Alternatively, major accounting firms may choose to offer their own respective brands of standards, and get them approved by the regulators.

Competition among standards would be accompanied by competition among the standard-writing organizations. The FASB and the IASB, for example, would become competitors for royalties paid by the public firms who choose to use their brand name by claiming that their financial reports conform to the standards of the chosen organization. Such royalties would be the sole source of revenue for the standard-setting organizations (and the FASB, for example, would have to forego the revenues under the provisions of the Sarbanes-Oxley Act).

Competition is the best known catalyst for efficiency and innovation and keeping things simple. It forces rule-making organizations to make difficult trade-offs they are otherwise reluctant to make. When they receive a request for “clarification,” each standard setter will have to think hard about the possible effect of increased complexity on its royalty revenue stream via reactions of the investment and corporate constituencies. Moreover, competitive standards will allow market feedback to enter the decisions of the rulewriters, so they can learn from mistakes of their own as well as others.

Under a monopoly regime where all firms must use the same standards, there is no way of conducting market studies to observe the consequences of alternative standards. Under
competition, rule-makers will obtain feedback signals from the market and learn not only from mistakes of our own, but also from others.’

A competitive system may converge to a single system, or may yield standards that appeal to various clienteles, e.g., multinational firms vs. medium vs. small and local enterprises, and different industries.

Will standards competition generate a race to the bottom? Regulatory approval and oversight is the first protection against the race to the bottom. Second, standards competition is common among stock exchanges, bond rates, universities and their accreditation bodies, federal and state bank regulators, and the corporate charter laws of the fifty states of the Union. There is little evidence of a race to the bottom in any of these fields.

Will multiple standards cause confusion in security markets? Markets already deal with multiple standards applicable in various jurisdictions without much problem. Moreover, in a world of computer worksheets, a couple of million dollars can create software which can produce relatively accurate estimates of financial reports prepared under alternative sets of financial standards at the touch of a button.

The FAF and the FASB already have the prestige and name recognition. Their standards can compete globally if they transformed themselves itself into global organizations. Their advantage is fast disappearing because, as a matter of national sovereignty and pride, many countries in the world would not choose the standards written by a US national organization over the “International.”

US cannot maintain its place in the capital markets of the world by isolating itself. We can hardly do better than to introduce an element of competition and market feedback in helping us discover better methods of financial reporting. Given understandable national sensitivities in all parts of the world, insistence on the current monopoly model of standard setting, and the exclusive US control of the FASB, leaves virtually the entire globe as exclusive playground for the competition.

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FAF Board Meeting
Feb 26, 2007

1. Thank you.

2. AAA founded 1916 voluntary, excellence in acq
   Ed, Res, Practice, 25%, 8%

3. Diversity of perspectives in academia. Liberty of
   presenting a perspective of my own as a sample
   FAF etc could tap into the broad spectrum of
   such perspective if they see fit to innovate
   ideas.

   FASB/GASB have been pioneers in USA the world

5. Still determining what kind of financial reports
   will best serve society (and what kind of
   institutional arrangements could develop such
   systems) is a major challenge.

6. I would like to share some ideas on meeting
   this challenge.

7. Major changes in 20th century.
   From social norms/common law model to
   written stats/statutory law model.

8. Law now both: juries decide
   Accr balance has shifted away from common
   laws.
9. Consequences of codification
   Endless detail with no countervailing force
e to put limits on detail

10. Rules vs. principles — False debate
    Structural Imperative

11. How do we introduce a countervailing force
to balance the tendency towards ever more
detail in standards?

12. Standards competition.
    Bond ratings, bank regulation, universities,

13. Each jurisdiction allows standards to compete
    Financed by user fees
    Free to find a niche.
    SEC - EU eliminate monopolies
    Mkt/user feedback into standards process

    Let FASB compete with IASB
    Stop convergence. Work independently
    Become an international organization
    Let cos. & investors have a choice
    Benefit from diversity & experience
    Excel whilesheet

15. FASB has no future in its current form. Losing battle
Just some ideas in these few minutes. Will be good to elaborate.

Academics don't have much to contribute to your important work except ideas. Many ideas are crazy. You can pick and choose. My colleagues in AAA have plenty to pick from. Thank you.
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Guest Speakers
Micah Green (Co-Chief Executive Officer, SIFMA)
Mark Lackritz (Co-Chief Executive Officer, SIFMA)
Shyam Sunder (President, American Accounting Association)