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April 18, 2009

Via Email (rule-comments@sec.gov)

Florence E. Harmon
Acting Secretary,
Securities and Exchange Commission
100 F Street NE
Washington, DC
20549-1090

Re: File Number S7-27-08:

Comments on SEC Proposed Rule on ROADMAP FOR POTENTIAL USE OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) BY U.S. ISSUERS

Thank you for inviting comments on the proposed rule on roadmap for the use of IFRS by U.S. issuers. My comments are enclosed, along with two papers that give detailed analysis as the basis of these comments.

Please contact me (shyam.sunder@yale.edu or 1.203.432.6160) for clarifications or discussion.

Sincerely,

Shyam Sunder

ROADMAP FOR POTENTIAL USE OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) BY U.S. ISSUERS

Re: File Number S7-27-08

Shyam Sunder
Yale School of Management
April 17, 2009

INTRODUCTION

The Securities and Exchange Commission (SEC) recently issued a call for comment on a proposal (henceforth the Proposal) on a roadmap for potential use of International Financial Reporting Standards (henceforth IFRS) by U.S. Issuers. I have examined the questions of accounting standards and policy, including some of the questions raised by the Commission. In this letter of comment I respond to some of the questions raised by the Commission and enclose the explanations for my answers in the form of some papers. The pagination refers to the 165 page document issued by the Commission.

1. SEC Proposal (Page 9):

"The Commission is proposing this Roadmap towards requiring the use of International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB")28 by U.S. issuers29 as part of its consideration of the role a single set of high-quality accounting standards plays in investor protection and the efficiency and effectiveness of capital formation and allocation. As capital markets have become increasingly global, U.S. investors have a corresponding increase in international investment opportunities. In this environment, we believe that U.S. investors would benefit from an enhanced ability to compare financial information of U.S. companies with that of non-U.S. companies. The Commission has long expressed its support for a single set of high-quality global accounting standards as an important means of enhancing this comparability.30 We believe that IFRS has the potential to best provide the common platform on which companies can report and investors can compare financial information."

Comments:

Single: There is no evidence that a single standard is better than multiple competing standards. Jamal and Sunder's (2007) comparison across industries where thousands of standard setting bodies set tens of thousands of standards, there is no evidence to support the assumption of the superiority of "single standard" that lies at the root of the proposal to create this global monopoly.

Jamal, Karim and Shyam Sunder. "Monopoly or Competition:Standard Setting in the Private and Public Sector." December 2007. http://ssrn.com/abstract=1075705 or http://www.som.yale.edu/faculty/Sunder/Jamal%20Sunder%20Stds%20Dec%2014.pdf.

High quality: In documents issued by the FASB, IASB and the SEC, the label of "high quality" is used repeatedly but hardly defined. What is a high quality standard? If "High quality accounting standards consist of a set of neutral principles that require consistent, comparable, relevant and reliable information that is useful for investors" (see footnote 58), which standards issued during the past three decades are not of high quality? How do we define and measure quality of a standard? Is it possible to get some broad agreement among a set of experts that, standard A is of higher quality than standard B in a given application. The term is borrowed from manufacturing contexts where engineers can objectively define and measure quality in terms of durability, functionality, precision, attractiveness, etc. In those contexts, it is a useful and valuable construct. In the context of financial reporting standards, there is little to suggest that quality can be used in any meaningful sense which is broadly agreed upon. Joyce, Libby and Sunder (1982) tried to measure the quality of accounting rules as judged by the current and former standard setters (a group of highly regarded experts by any measure) and found little agreement on quality. In fact, reasonable standards are those that make an acceptable trade-offs among conflicting characteristics and interests of various parties, and negotiation and bargaining among the interested parties are essential elements of identifying such standards. Unless the Commission defines and proposes the "right" trade offs among the characteristics of standards (which is very difficult to do) little is gained by repeated high quality as a mantra in the official pronouncements.

Joyce, Edward J., Robert Libby, and Shyam Sunder. "FASB's Qualitative Characteristics of Accounting Information: A Study of Definitions and Validity." *Journal of Accounting Research* 20, no. 2, pt. II (Autumn 1982): 654-675. http://www.som.yale.edu/faculty/Sunder/Research/Accounting%20and%20Control/Published%20Articles/31.FASBs%20Qualitative/31.FASBQualCharAcctInfo.JAR1982.pdf.

Investor protection and the efficiency and effectiveness of capital formation and allocation: U.S. securities laws and the Commission were created for the sake of investor protection. Inclusion of efficiency and effectiveness of capital formation is a worthy addition to its charge. Indeed, accounting and accounting standards do play a role in this respect, and if the actions of the Commission were to adversely affect capital formation and allocation processes, it would not be desirable from the point of economic welfare of society. However, there are other roles that accounting and accounting standards play which are equally if not more important for the economic welfare of society. Most important and widely discussed of these roles is the effect of standards on stewardship and efficiency of management of enterprises. Since the Commission seems to be willing to go beyond its statutory charge into other roles of accounting in society and enterprises, it should not ignore the stewardship role of accounting standards in efficiency of management.

Downplaying of the stewardship role in accounting standard making has led to tragic consequences during the past decade. In the context of large performance-contingent compensation packages for corporate executives, adoption of mark-to-market accounting (under the guise of "fair" values) resulted in large wealth transfers away from shareholders and induced management of financial and other organizations to create, trade, and hold "toxic" assets which have taken the U.S. and the world economy to the brink of collapse. Perhaps a consideration of the stewardship consequences of mark-to-market accounting might have reduced the possibility of this outcome.

Educational and professional consequences of accounting standards is a second important factor that the Commission could advantageously consider in its deliberations (see Sunder 2009a, 2009b).

Sunder, Shyam. "IFRS and the Accounting Consensus" *Accounting Horizons* Vol. 23, No.1 (March 2009a) pp. 101-111. http://www.som.yale.edu/faculty/Sunder/Research/Accounting%20and%20Control/Published%20Articles/160.IFRSAccountingConsensus/IFRS-AccountingConsensusMarch09.pdf.

Sunder, Shyam. "Adverse Effects of Accounting Uniformity on Practice, Education, and Research." November 2009b. http://ssrn.com/abstract=1028517 or http://www.som.yale.edu/faculty/Sunder/Research/Accounting%20and%20Control/Presentations%20and%20Working%20Papers/AdverseEffectsofAccountingUniformityonPracticeRevNov5.pdf.

I am delighted to see that the Commission is willingness to go beyond its statutory charge and examine other aspects of consequences of accounting standards before approving them. I support the idea of including the efficiency and effectiveness of capital formation and allocation, and hope that the commission will not stop there and include at least the stewardship and educational consequences of accounting standards in its deliberations.

Ability to compare: Ability of the users of financial reports to compare across enterprises, industries, and countries is appropriately recognized as a important desirable feature. What is not clear is how written standards of financial reporting, especially those written by a single body for the entire diverse world of enterprises and economies in the globe, promotes comparability. As I explain in Sunder (2009a), even in the simplest example of accounting for research and development outlays, the effect of written standards (FAS 2) in increasing comparability of financial reports is questionable. The same argument applies to other aspects of financial reporting. When corporations, industries, economies, laws, governance, market structures, and commercial codes differ across the world, there is no meaningful sense in which a single set of financial reporting standards can bring greater comparability. If they do, the Commission should establish that fact, and not take it for granted.

2. Seven Milestones (Page 10):

• **Improvements in accounting standards**; (comment: see the paragraph on "high quality" above)

• **The accountability and funding of the IASC Foundation**; (comment: Providing secure tax-based funding for the IASB, and other standard setting organizations induces them to accumulate thicker rulebooks over time. The dream of keep accounting standards at general principles would be the first casualty of secured funding over time. Pressure from users, who may refuse to adopt and thus deny royalties to a standards regime that becomes overly complex for their purposes, can constrain and discipline the standard setters.)

• **The improvement in the ability to use interactive data for IFRS reporting**; (comment: The design of XBRL is based on the idea of a classification scheme that can stay ahead of the financial engineers determined to undermine the financial reporting system. Given the asymmetry of the comparatively slow speed with which standard setters and XBRL evolve, this is a losing battle.)

• **Education and training relating to IFRS**; (comment: Instead of adding a set of specific standards to the curriculum, it is better to raise the accounting education to a level so the graduates develop the ability to read, apply and use any given set of standards that they come across. Accountants can take a leaf from lawyers' book; the latter do not try to teach the specifics of the laws of the fifty states. Instead, they try to teach law at a sufficiently high level of generality so, upon graduation, the lawyers can read and apply the law of whichever state they choose to practice in. Such specifics are left to be learnt during the bar exam preparation, and not covered in university curricula. Accounting education could also benefit from this approach, instead of promoting instructions in the specific details of one or another system of standards.)

• **Limited early use of IFRS where this would enhance comparability for U.S. investors**; (comment: allowing registrants a choice among two or more carefully chosen sets of standards will eliminate the need for a mandate.)

• **The anticipated timing of future rulemaking by the Commission**; (comment: permission to elect IFRS, with a five-year constraint on switching accounting standards, will eliminate the need for this rulemaking.)

• **The implementation of the mandatory use of IFRS by U.S.** (comment: permitting voluntary election of IFRS when registrants so decide will eliminate the need for the proposed mandate.)

3. Adoption of IFRS in 113 Countries (page 13):review the substance of the claim of adoption of IFRS in 113 countries before making it a requirement in the U.S. Anecdotal evidence on adoption of IFRS suggests major discrepancies across countries in how the presumably common standards are interpreted and applied. Noncomparability of business and accounting words in various languages makes it virtually impossible to translate precisely the English original of IFRS into most other languages. Some countries use their own interpretation of IFRS while claiming that they conform to the IFRS in order to appear attractive to foreign investors. There is no mechanism to examine the validity of such claims by the IASB that appears interested in claiming conformity in as large a number of jurisdictions as possible. Given the long-standing arguments on Big GAAP-Small GAAP, and industry specific GAAPs within U.S., it appears unlikely that the uniformity across the globe is either desirable or achievable.

4. Response to Request for Comment (page 48-51)

1. Do commenters agree that U.S. investors, U.S. issuers and U.S. markets would benefit from the development and use of a single set of globally accepted accounting standards? Why or why not? What are commenters' views on the potential for IFRS as issued by the IASB as the single set of globally accepted accounting standards?

Comment: Half-a-century of experience has revealed that it is difficult for any standard setting organization to know, ex ante, which standards are better than others. A standard maker with a global monopoly will have even greater difficulty in finding out which standards are better because it will become impossible to experiment, compare, and learn from experience. If Apple iPhone were granted the global monopoly (assuming that it were universally accepted that it is the best smart phone in the world today), a few years from now, the world would be worse off because this action will kill off further product innovation in the smart phone industry. Since the accounting standard setters must constantly struggle with having to devise ways of dealing with the financial engineering products specifically designed to get around the intent of financial standards, the ability of standard setter to learn from comparison is critical to its effectiveness. The proposed action of mandated (not elective) use of IFRS in US will unnecessarily tie the hands of the standard setter by closing off its opportunity to learn from an open environment.

2. Do commenters agree that the milestones and considerations described in Section III.A. of this release ("Milestones to be Achieved Leading to the Use of IFRS by U.S. Issuers") comprise a framework through which the Commission can effectively evaluate whether IFRS financial statements should be used by U.S. issuers in their filings with the Commission? Are any of the proposed milestones not relevant to the Commission's evaluation? Are there any other milestones that the Commission should consider?

Comment: For reasons explained above under the milestones, these are not applicable. There is no reasonable and broadly acceptable basis on which the Commission can assess the improvement, and tax-based funding will simply create a permanent organizational structure which will gradually accumulate the complexity and detail of financial standards over the years. Please see the comments above under the milestones.

3. Do commenters agree with the timing presented by the milestones? Why or why not? In particular, do commenters agree that the Commission should make a determination in 2011

whether to require use of IFRS by U.S. issuers? Should the Commission make a determination earlier or later than 2011? Are there any other timing considerations that the Commission should take into account?

Comment: For reasons given above, the Commission should not make a determination in 2011, or ever, to mandate the use of IFRS by U.S. issuers. Instead, it should permit them elective use of IFRS at an early date.

4. What are commenters' views on the mandated use of IFRS by U.S. issuers beginning in 2014, on an either staged-transition or non-staged transition basis? Should the date for mandated use be earlier or later? If the Commission requires the use of IFRS, should it do so on a staged or sequenced basis? If a staged or sequenced basis would be appropriate, what are commenters' views on the types of U.S. issuers that should first be subject to a requirement to file IFRS financial statements and those that should come later in time? Should any sequenced transition be based on the existing definitions of large accelerated filer and accelerated filer? Should the time period between stages be longer than one year, such as two or three years?

Comment: Instead of mandating the use of IFRS, Commission should let the registrants elect if they wish to use IFRS or U.S. GAAP, and restrict them from switching among standards within five years of the election.

5. What do commenters believe would be the effect on convergence if the Commission were to follow the proposed Roadmap or allow certain U.S. issuers to use IFRS as proposed?

Comment: Registrants in U.S. and abroad will claim to comply with IFRS in form but not in substance. It is better to have two or more sets of standards, say IFRS and US GAAP, remain in business indefinitely. They may tend toward each other, or they may diverge and attract their own respective clienteles as the New York Stock Exchange and

NASDAQ do among listed firms. Without the less stringent requirements of NASDAQ which permitted smaller firms to raise equity capital, it is not clear how much of the technology revolution would have taken place. The diversity of accounting standards, under control and supervision of the Commission, will serve the economy better.

6. Is it appropriate to exclude investment companies and other regulated entities filing or furnishing reports with the Commission from the scope of this Roadmap? Should any Roadmap to move to IFRS include these entities within its scope? Should these considerations be a part of the Roadmap? Are there other classes of issuers that should be excluded from present consideration and be addressed separately?

Comment: This question recognizes the possibility that the same set of standards may not be appropriate for all industries. Which standards are better for which industry is best determined by interaction among registrants, investors, auditors and regulators over time. This is one more reason why the Commission should not push toward creating a global monopoly.

7. Do commenters agree that these matters would affect market participants in the United States as described above? What other matters may affect market participants? Are there other market participants that would be affected by the use by U.S. issuers of IFRS in their Commission filings? If so, who are they and how would they be affected?

Comment: These matters not only have a direct effect on investors, they also have an indirect longer term effect on investors through altering accounting education, the level of talent attracted to accounting profession, and ultimately the profession itself. An accounting standards monopoly will further push accounting instruction toward rote learning of authoritative rules in the classrooms, de-emphasize rational discourse and analysis of alternatives, drive away talented students from accounting programs, and ultimately weaken the accounting profession to the detriment of the investors and the economy (Sunder 2009a, 2009b). This should be a legitimate concern of the Commission in its rulemaking activities.

Sunder, Shyam. "IFRS and the Accounting Consensus" *Accounting Horizons* Vol. 23, No.1 (March 2009a) pp. 101-111. http://ssrn.com/abstract=1208502 or http://www.som.yale.edu/faculty/Sunder/Research/Accounting%20and%20Control/Published%20Articles/160.IFRSAccountingConsensus/IFRS-AccountingConsensusMarch09.pdf.

Sunder, Shyam. "Adverse Effects of Accounting Uniformity on Practice, Education, and Research." November 2009b. http://www.som.yale.edu/faculty/Sunder/Research/Accounting%20and%20Control/Presentations%20and%20Working%20Papers/AdverseEffectsofAccountingUniformityonPracticeRevNov5.pdf.

8. Would a requirement that U.S. issuers file financial statements prepared in accordance with IFRS have any effect on audit quality, the availability of audit services, or concentration of market share among certain audit firms (such as firms with existing international networks)? Would such a requirement affect the competitive position of some audit firms? If the competitiveness of some firms would be adversely affected, would these effects be disproportionately felt by firms other than the largest firms?

Comment: The large international "network" firms may use their international aura and link it to IFRS as having greater expertise than their smaller competitors. Commission's mandate for US registrants to use IFRS may place the smaller firms at a relative disadvantage, and result in a further increase in the concentration in the market for audit services.

9. What are commenters' views on the IASB’s and FASB’s joint work plan? Does the work plan serve to promote a single set of high-quality globally accepted accounting standards? Why or why not?

Comment: As explained above, their joint work will not serve the best interests of financial reporting. It is better that they are asked to work entirely independently to devise their own standards and attempt to attract clientele willing to pay them royalties. The joint work plan also assumes that there are no political pressures specific to countries involved. As is clear from the recent congressional pressure with respect to mark-to-market accounting in the U.S., this is not true, never has been, or will be. In any case, how would a single global body find out and establish that its standards are indeed of “high quality?”

10. How will the Commission's expectation of progress on the IASB’s and FASB’s joint work plan impact U.S. investors, U.S. issuers, and U.S. markets? What steps should be taken to promote further progress by the two standard setters?

Comment: To serve the best interests of U.S. investors, issuers, and markets, the two boards should be asked to work independently of each other.

11. The current phase of the IASB’s and FASB’s joint work plan is scheduled to end in 2011. How should the Commission measure the IASB’s and FASB's progress on a going-forward basis? What factors should the Commission evaluate in assessing the IASB's and the FASB's work under the joint work plan?

Comment: I can think of no rational basis the Commission could use to evaluate their joint work plan. It is better to abandon the joint work plan itself for the reasons explained above.

12. What are investors', U.S. issuers', and other market participants' views on the resolution of the IASB governance and funding issues identified in this release?

Comment: Incentives and governance of the standard setting boards should be designed so they would best serve the interests of the investors, issuers and markets. This can be done if they were to compete for royalties for the use of their standards collected from registrants. This competition will be subject to the supervisory oversight of the Commission to prevent any risk of race to the bottom.

13. What steps should the Commission and others take in order to determine whether U.S. investors, U.S. issuers, and other market participants are ready to transition to IFRS? How should the Commission measure the progress of U.S. investors, U.S. issuers, and other market participants in this area? What specific factors should the Commission consider?

Comment: The Commission can give them an option to choose, and they would switch if and when they are ready and find it in the best interests of investors and issuers. This will help reduce the burden of analysis and decision making on the Commission.

14. Are there any other significant issues the Commission should evaluate in assessing whether IFRS is sufficiently comprehensive?

Comment: The Commission should not allow itself to be carried away by the rhetoric of rules vs. principles often used in the context over the past decade. IFRS rule book is thinner than FASB's because they have not been in business for very long. The nature of their output is a function of their structure, not intent. Two bodies with similar structures and financing will write standards with similar characteristics and detail. Having created a global monopoly financed by guaranteed tax revenues, the Commission will discover within a decade that the standards devised by the IASB will come to have the same level of detail and specificity in them as the FASB's standards do. If the Commission favors simpler financial reporting based on principles, it should consider a competitive model, and promote creation of an accounting court (proposed by Leonard Spacek in the 1960s) which judges financial reporting by the compass of "true and fair" representation. Business and accounting community will also have to take some responsibility for their social norms; financial reporting cannot depend on written standards alone (Sunder 2005).

Sunder, Shyam. "Minding Our Manners: Accounting as Social Norms." *The British Accounting Review* 37 (December 2005): 367-387. http://www.som.yale.edu/faculty/Sunder/Research/Accounting%20and%20Control/Published%20Articles/128.Minding%20Our%20Manners/MindingOurMannersPublished.pdf.

5. Regulatory Flexibility Act Certification (pages 142-143)

Comment: It is not clear how the Commission can certify that the proposed requirement for all U.S. registrants to use IFRS "would not have a significant economic impact on a substantial number of small entities." The Commission should consider (a) that most of these entities have little international investment or exposure to international capital markets; (b) given their small size, adoption of IFRS will put a disproportionate financial burden on them; and (c) even if the smaller firms are given the choice to stay with U.S. GAAP, to the extent the larger firms are required to switch to IFRS, the use of different standards will open a wedge in the access smaller firms have to the capital markets. There is a good chance that if the larger firms are required to adopt IFRS, investment bankers and perhaps even commercial bankers will force the smaller firms to conform to IFRS before granting them access to equity or loan capital. For these reasons, such certification by the Commission seems unjustified.

6. Consideration of Impact on the Economy, Burden on Competition and Promotion of Efficiency, Competition and Capital Formation (page 143-146)

70. Would the proposed amendments, if adopted, promote efficiency, competition and capital formation?

> Comment: Commission's proposal is based on one key assumption: A single accounting standards setting board, charged with the responsibility to develop global standards, can efficiently identify better standards. If it could, the expectations about the resulting benefits of efficency from competition would follow. Unfortunately, there is a considerable amount of economic theory starting with Hayek (1945), and accounting and regulatory experience since the 1930s, that raise serious questions about the validity of this assumption. In developing this proposal, the Commission has focused its attention the efficiencies in capital investment and allocation that may arise from a single set of standards. It seems to have paid little attention to the inefficiencies that arise from having a wrong set of standards, and the increased likelihood that a global regulatory monopoly, deprived of the benefits of experimentation, comparison and learning, will arrive at a wrong set of standards, which will be difficult to change. Thus the Commission's argument holds in a narrow sense, but not in the broader picture when we consider the increased potential for mistakes the standard setters may make.
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> Friedrich A. Hayek. 1945. "The Use of Knowledge in Society," American Economic Review, Vol. 35 NO. 4, pp. 519-30. http://www.econlib.org/library/Essays/hykKnw1.html.

In summary, I suggest that the Commission allow U.S. registrants the choice of reporting by U.S. GAAP (written by the FASB), the IFRS (written by the IASB), and perhaps one or two other sets of standards (e.g., Canadian standards written by CICA) as long as (1) they conform to the "high quality" as judged by the Commission on an annual basis; (2) each standard writing organization acts independently, and without collusion with others; and (3) earns its revenues solely through royalties earned from the registrants who choose their standards. Standard writers, like all other mortals, learn from experimentation, trial and error, and experience. Car manufacturers compete in thousand ways to find better ways of meeting the safety standards for automobiles while making their cars attractive and affordable to their customers. Allowed similar room for competition and creativity under the supervisory oversight of the Commission, there is reason to think that a small set of independent standard setters will help evolve better financial reporting system than is likely under a system that grants tax-financed monopoly to a single standard setter.

I have appended two papers, "IFRS and the Accounting Consensus" and "Adverse Effects of Uniform Written Reporting Standards on Accounting Practice, Education and Research" which include more detailed analysis.

Sincerely,

Shyam Sunder

Encl: Appendix I and II

Appendix I: Shyam Sunder. 2009. “IFRS and the Accounting Consensus,” *Accounting Horizons* Vol 23, No. 1 (March), pp. 101-111.

IFRS and the Accounting Consensus

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Abstract

A broad consensus in accounting favors principles over rules to guide creation of a uniform high quality set of standards for use everywhere, and granting monopoly power to a single body for this purpose. If implemented into policy, this consensus will discourage discovery of and evolution toward better methods of financial reporting, make it difficult to conduct comparative studies of the consequences of using alternative methods of accounting, promote substitution of analysis and thinking by rote learning in accounting classes, help discourage talented youth from collegiate programs in accounting, and probably endanger the place of accounting discipline in university curricula. Because the presumed benefits in the form of increased comparability of financial reports internationally or stateside are unlikely to be realized, the wisdom of undertaking these burdens remains questionable. The paper calls for a re-examination of the accounting consensus.

Key Words: accounting education, accounting standards, IFRS, uniformity

JEL Codes: M41, M44

An earlier draft of this paper was presented at the Deloitte-Federation of Schools of Accountancy Faculty Consortium, June 15–16, 2008, Chicago. Without implicating them, the author is grateful to Rick Antle, Alan Reinstein, Manjula Shyam, the participants in the Deloitte-FSA Consortium, EIASM Workshop on Accounting and Economics in Milan, Temple University, and two referees for their helpful comments and suggestions on earlier drafts. Please send comments to Shyam.sunder@yale.edu.

IFRS and the Accounting Consensus

This paper presents a heterodox perspective on International Financial Reporting Standards (IFRS). Although the development of another set of accounting standards is a good idea, I present a case that its application to all public firms across most countries of the world through regulatory fiat is not.

"Get aboard if you do not wish to be left behind on the platform" is not a good reason to follow the crowd, especially in matter of policy with longer-term consequences.[1] Caution against the bandwagon approach applies to smoking and drugs in schools, investment in real estate or stock markets, choice of careers, and many other aspects of our lives, society, and economy. Consider one example.

Through the 1980s and the 1990s, the International Monetary Fund, the World Bank, and the U.S. Department of Treasury were associated with a more or less standardized mix of policy prescriptions for reforming the economies of countries in financial crisis (Williamson 1990). This policy mélange was administered, sometimes in the face of considerable resistance, to developing countries that got into economic difficulties and turned to these institutions for help. The prescription included bitter pills of fiscal discipline, redirection of public spending; tax reform; financial, trade, and investment liberalization; privatization, deregulation, and greater roles for market forces and protection of property rights.

1 The U.S. Securities and Exchange Commission announced (on August 27, 2008) and issued (on November 14, 2008) a "roadmap for the potential use of financial statements prepared in accordance with International Financial Reporting Standards setting several milestones that, if achieved, could lead to the required use of IFRS by U.S. issuers in 2014" (SEC 2008a, 2008b).

Until about ten years ago, virtually everyone with power in the world of international finance and economics appeared to support the idea. By the end of the nineties, the consensus evaporated (Naim 2000), was modified (Rodrik 2001), and attacked (Stiglitz 2002; Finnegan 2003). After its fall from grace, and with the hindsight on its consequences, it is difficult to locate its supporters even in Washington, London, or Tokyo, much less in Buenos Aires, Mexico City, or Jakarta.

Keeping the saga of Washington Consensus in mind, it might be worth thinking of the current Accounting Consensus, identifying its main elements, examining whether it is better grounded in facts than its celebrated predecessor was, assessing its implications for accounting practice and education, and rethinking what we should and should not do, before accountants and accounting teachers snap to attention on orders from authorities. Civil servants, politicians, experts, and academics are all susceptible to errors of judgment. Our only protection is to try to minimize the frequency and impact of such errors by thinking hard and debating the issues in the community before taking major policy steps. Perhaps it is fortunate that this debate seems to be starting up, and regulators would be well advised not to act precipitously.[2]

An examination of the elements of the current accounting consensus shows that most of it is built on questionable foundations. I shall also argue that, if pursued by the accounting profession and educators, it will bring harm to the quality of accounting education, our ability to attract and prepare talented young men and women for the profession, and will further endanger the place of accounting education in our universities. Each educator should think what monopoly

2 The ranks of those who question the merits of SEC's recent proposals on accounting standards now include a former member of the Financial Accounting Standards Board Edward Trott (Johnson 2008) and a current member of the Public Company Accounting Oversight Board Charles Niemeier (2008).

standardization of accounting and auditing have done, and may do to accounting education and the profession, and decide whether moving further down this road will help us serve our students and society better.

In my assessment, the consensus consists of five key elements:

1. The standards developed should be confined to principles and not become detailed rules.

2. A single set of high-quality written standards of financial reporting applied to all companies (at least the publicly traded ones) in the world will improve financial reporting by making financial reports more comparable, and thus help investors and other users of financial statements make better decisions.

3. To develop such standards, we should create a single deliberative corporate body consisting of chosen experts with a proper governance structure, due process, and legally assured funding, functioning under the oversight of regulatory authorities such as the Securities and Exchange Commission, the European Commission, or International Organization of Securities Commissions.

4. To this end, the operations of the FASB and the IASB should be coordinated and integrated to produce a single set of standards to be called, say, IFRS.

5. This single set of standards should be practiced in the United States, the European Union, and elsewhere, and the U.S. educational system should prepare itself to integrate IFRS into its curricula so U.S. graduates will be able to prepare, use, and audit financial reports based on IFRS.

In the following section I present the arguments as to why these elements of the Consensus are flawed.

1. **The standards developed should be confined to principles and not become detailed rules.**

Principles, not rules, seem to be at the core of the Accounting Consensus. Doubts arise about the substance of a consensus when everybody is for it, but nobody can tell you what it means, or give you some substantive examples. We know the biblical commandments—Thou shalt not steal, for example—as principles. Both IFRS as well as FAS exhibit wide variation in the level of detail in their individual pronouncements.[3] A recent compilation of international standards and their official interpretations and guidance published in March 2008 has 2,752 pages. One would have to think long and hard to find a profession whose principles require this many pages to state. It is difficult not to wonder about the distinction between principles and rules as visualized by the accounting standard writers.

Market valuation is a principle, as is historical cost valuation. In contrast, fairness is an *ex post* judgment about a particular instance of valuation in the eyes of preparers and users. Alternatively, it could be thought of as their *ex ante* judgment about the outcomes expected from a given method of valuation. How can a standard specify the numbers arrived at by the application of a particular method to be "fair" by definition?

Financial Accounting Standard 157 (FASB 2006) specified three unrelated valuation methods (mark-to-market, mark-to-model, and mark-to-judgment) to be used in different circumstances and declared their combination to be "fair." Note that the last of these three

3 For a comparative summary of IFRS and U.S. GAAP, see Deloitte (2007).

options allows firms to value assets as they deem fit when market values or model parameters cannot be objectively estimated. Warren Buffet pointed out that the third level of “fair” risks becoming mark-to-myth.[4] In mid-October 2008, in response to political pressures, the IASB (2008) proposed to allow special dispensation for application of fair values to financial instruments.[5] In what sense can this proposal be called a principle, and not the beginning of the slide down the proverbial slippery slope of clarifications and guidance that land the general principles in a morass of complex rules under pressure from money and power?

The nature of written standards depends not only on intent but even more so on the process of writing them. A key feature in the process of standard writing—consideration of business and politics—will be the same, whether the FASB or the IASB does the writing. It is unreasonable to expect that the IFRS, after having tumbled through this process over a few financial scandals and cycles of the world economy during the next couple of decades, will look any different than the FAS looks now, the rhetoric about rules versus principles notwithstanding.

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4 Berkshire Hathaway Inc. Shareholder Letter for 2002 (2003, 13): “In extreme cases, mark-to-model degenerates into what I would call mark-to-myth.”

5 Muñoz (2008) in the *Wall Street Journal*:

> The new accounting rules are “one of the many weapons being deployed to fix the banking crisis,” Belgian Finance Minister Didier Reynders said in an interview. “The IASB made some changes last week, allowing banks to reclassify assets such as loans and receivables. The IASB said it expedited its decision following requests from EU officials, who wanted to see the measure put in place quickly.” EU officials say that by month's end, the IASB changes could be broadened to include complex derivatives, a type of investment on which banks have already suffered tens of billions of dollars in write-downs.

It would be helpful to know the substance of the distinction between rules and principles in the context of what the FASB and the IASB have done in the past and plan to do in the future.

2. **A single set of high quality written standards of financial reporting applied to all companies (at least the publicly traded ones) in the world will improve financial reporting by making financial reports more comparable, and thus assist investors and other users of financial statements make better decisions.**

There is little doubt that investors prefer high quality standards over low. However, to impart an operational meaning to this preference, one should know the characteristics of a high quality accounting standard. How can one tell the quality of a standard? The length, specificity, generality, readability, and reliability are some of the possibilities that come to mind, but there are many others. Is it possible to put two standards, say those written by the FASB and the IASB, side-by-side and obtain some reasonable agreement across experts about their quality? To the best of my knowledge, neither the quality nor methods of measuring the quality of a standard have been specified or explained. A study of the qualitative characteristics of standards does not give us much hope that they have been identified in a useful way (Joyce et al. 1982). Much rhetoric about high quality standards appears in speeches and press releases, but surprisingly for organizations dedicated to telling the world how to measure things, no measure of quality of a standard is available. A car manufacturer cannot tout the quality of its parts for long without backing it up with substance. In comparison, measurement of the quality of accounting standards appears to be treated with remarkable indifference.

Facilitating comparability of financial statements is an important element of the Accounting Consensus. High quality standards based on principles instead of rules are supposed to help generate financial reports that are more useful by reason of being more comparable across firms, industries, and countries. This high-sounding goal deserves a moment of reflection. A general principle is concise and calls for judgment in its application, which must necessarily vary across individuals and situations, giving rise to greater variability in applications than a more detailed rule—presumably calling for less judgment—will generate. How and why should one expect that a resort to principles instead of rules would result in greater comparability?[6] The basis of this presumed insight of the Accounting Consensus remains a mystery; given its centrality, it is worth exploring further with an example.

Consider the problem of accounting for research and development outlays, an early project and pronouncement of the FASB. FAS 2 (FASB 1974) issued a year after it was established. Consider two companies: company A that spends $1 million on R&D and manages to get a patent of doubtful value, and company B that also spends $1 million on R&D and

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6 Personal conversations with senior partners of major accounting firms in United States and Europe reveal widespread skepticism about the proposition that IFRS will promote comparability, even as these firms continue to aggressively support the idea in their formal positions. Reason (2008) quotes an accounting consultant:

> …the root of their misunderstanding wasn't U.S. GAAP, but the fact that the Big Four partner was familiar with the U.S. version of IFRS, which differs subtly from IFRS as issued by the IASB.…I learned for the first time that IFRS isn't necessarily IFRS country-to-country. There are variants. Variations with IFRS are, in fact, one of the issues that the SEC says need to be addressed, and foreign-based firms listed in the U.S. can only file in IFRS if they use IASB-issued standards, not local variants. That said, if the SEC can't curb its own enthusiasm for issuing guidance, U.S. conversion to IFRS may simply add one more variation.

Apparently, the SEC, like regulators elsewhere, plans to pursue cross-country comparability by issuing its own interpretations and guidance! It would be an amusing comedy of errors if such contradictions did not have serious and potentially tragic consequences for accounting and accountants.

manages to develop a patent whose market value is estimated by the firm to be $10 million. Consider two possible standards: X that allows firms to capitalize that part of the R&D cost that does not exceed the firm's estimate of the value of the R&D; and standard Y that requires the firm to treat all R&D outlays as expense when incurred.

Under standard X, firm A could capitalize an amount between 0 and $1 million depending on what it claims to be the value of the future benefits of the R&D project. Firm B also could do the same, although it will likely capitalize the entire cost of $1 million. In any case, to the user of the statements the two companies could look the same when their underlying states are entirely different. This is the problem that led the FASB to issue its FAS 2 in 1974 (labeled Y in this discussion).

Under standard Y, both firms must expense the $1 million outlay against the current period income, and their balance sheets and income statement for the year would be identical (other things being the same) when, in fact, their underlying economic situations are quite different. They are comparable in the sense that they both spent the same amount of money on R&D during the year, and both show this entire amount as a charge against current income. They are also comparable in the sense that they have no resulting assets on their balance sheets. However, they are not comparable in the sense that while standard Y (the current method) reveals the economic situation of firm A in its financial statements quite accurately, it misleads the user about the valuable resource of a patent firm B has but does not show on its balance sheet. So, even in this simplest of accounting examples, it is not clear which of these two possible standards is of higher quality and which one results in financial statements that are more comparable—an attribute so highly valued in the Accounting Consensus and yet hard to define.

Of course, no evidence exists that either of the two boards have tended to issue standards that help investors or other users make better decisions. If such evidence is available, it should be shared with the public for their assessment.

3. **To develop such standards, we should create a single deliberative corporate body consisting of chosen experts with a proper governance structure, due process, and legally assured funding, functioning under the oversight of regulatory authorities such as the Securities and Exchange Commission, the European Commission, or International Organization of Securities Commissions.**

It is difficult for regulators accurately to assess the consequences of their proposed actions. The complex interactions among interests and actions of numerous agents make it difficult for any one regulatory body to assess, *ex ante*, the final consequences of implementing a proposal and its ultimate desirability.[7] Most feedback they receive from individuals on their proposed drafts is understandably motivated by self-interest, sometimes apoplectic, and is rarely balanced across various interest groups whose ability to organize and respond differs widely.

Even in simple design tasks, say a toaster or a voting machine, engineers must test prototypes in the field to assess the strengths and weaknesses of alternative designs. The task of designing an accounting standard—which affects millions of individuals, all with potential to modify their actions in response to the standard—is far more complex. Designing it right in the first place without a field trial is almost impossible. Sole dependence on the judgments of a

7 For example, see IASB (2008, 4): "After IFRS 7 was applied in 2007, the Board was informed that some of the disclosure requirements about the nature and extent of liquidity risk were unclear and difficult to apply and did not always result in useful information for users of financial statements."

single regulatory body, with a world-wide monopoly jurisdiction, deprives it of the benefits of market feedback,[8] and discourages search for, experimentation with, and ultimate adoption of innovative solutions to financial reporting problems. Under a monopoly regulator, learning from trial-and-error and from alternative practices is not possible. Even in the unlikely event that a single best-for-all standard exists, the probability that it can be discovered through a monopoly process is low. Such a process will get us boxed in a wrong solution with high probability, and we would not have access to evidence or experience with alternatives to guide improvement of its prescriptions through learning and comparison.[9] Reduction in the number of paths for evolutionary change is an important adverse consequence of granting the authority for world-wide standards to a single regulator with jurisdiction around the world.

Simplicity and Complexity. Organization and rules of markets are often simple, but the interactions among market participants can be maddeningly complex. Instead of the "simple rules, complex behavior" approach of markets, financial reporting has taken the opposite route of trying to make the task of the accountant and auditor simple by writing increasingly complex rules. Accounting standard setters seek to minimize the need for judgment by responding to requests for clarification of their rules. Unfortunately, when the goal is to narrow the scope of judgment and personal responsibility of the preparer and the auditor for the truthfulness and fairness of the final report, there can be no end to demands for clarifications, and the result is increasing complexity. Law tries to secure just outcomes through a combination of statutory and

8 See Hayek (1945).

9 Barth et al. (2007), for example, compare the quality of financial reporting across twenty-one countries for firms that do and do not use international accounting standards. Once all (major) economies adopt IFRS, data for such comparative studies will no longer be available.

case law and ultimate judgments of lay jurors. Perhaps accounting, too, could handle the problem though a combination of written standards, social norms, and professional judgment, exercising self-restraint through sparing use of the power of enforcement. Heavy-handed intervention by rule-making monopolies and active enforcement by the power of state have failed to improve financial reporting and are unlikely to do so in the future.

It has been suggested that the economy, including corporations, markets, and financial reporting, should not be seen as a machine with fixed components, properties, and functional relationships. Instead it is best seen as an ecosystem whose elements continually adjust with respect to one another and evolve over time.[10] Just as the acceptance of the ecosystem idea deconstructed the human/nature dichotomy, recognition of financial reporting as an ecosystem may also help us turn away from the preparer/user, transaction-event/information dichotomies that lie at the heart of the recent approach to financial reporting.

Although regulatory bodies resist competition within their jurisdictions, they have little reason to deny themselves the benefits of discovery and innovation when multiple entities compete. The National Highway Traffic Safety Administration (NHTSA) benefits from competition among car manufacturers who profit from devising better and cheaper ways to achieve the safety benchmarks set by the NHTSA. The Environmental Protection Agency (EPA) benefits from competition to devise better ways of achieving its pollution targets. The Securities and Exchange Commission (SEC) or the European Commission (EC) have little reason to deny themselves the benefits of better ways of financial reporting that could be discovered through

10 Arthur Roy Clapham coined the term *ecosystem* in the early 1930s in response to a request from Arthur Tansley (Willis 1997).

competition between the FASB, the IASB, and possibly some others.[11] The number of automobile engine designs that are present in the market is determined by the trade-off between the presumed advantages of newer designs and many additional costs including the parts inventory and the skill set of mechanics. Even if there were world-wide consensus that manufacturer X makes the best cars or computers at the present time, closing down the competing manufacturers would hardly be a wise course of action. Just as car repair shops figure out the ways of handling the diverse systems sold by different manufacturers, financial analysts can develop the expertise to analyze the financial statements prepared under competing standards.

Such competition cannot occur if, as the Accounting Consensus suggests, the standard setting agencies are assured of tax revenues to pay their expenses. Like other organizations, they would innovate and make the difficult trade-offs necessary to limit the complexity of their standards if they had to earn their own way in the form of royalties gathered from organizations that choose to claim that their financial reports conform to their respective standards. Any tendencies of the standard setters to race to the bottom would be counterbalanced by the self-interest of investors and analysts on one hand, and the vigilance of the statutory regulators on the other. The U.S. bond-rating agencies (Moody’s, Standard and Poor’s, and Fitch), who once showed signs of racing to the bottom in markets for subprime mortgage-based markets, improved on being disciplined by the markets as well as statutory regulators in the first half of 2008.

11 AICPA (2008) revised its Rule 203 to include IFRS alongside FAS as an authoritative set of standards in the U.S. for a 3-5 year “trial” period. Besides helping the nonpublic companies, such professional recognition of multiple sets of standards may help keep the CPA exam focused on general principles of accounting. It would be a step in the

4. **To this end, the operations of the FASB and the IASB should be coordinated and integrated to produce a single set of standards to be called, say, IFRS.**

A single set of accounting standards holds significant appeal through popularly drawn parallels with weights and measures in engineering and commerce, and with natural languages. Uniform weights and measures as a function of state appeared early in human civilizations to promote commerce; a common language makes communication possible. The first parallel is misleading; the second is often misunderstood.

If accounting measurement were like the measurement of gasoline by gallons, the uniform expensing of all research and development outlays as prescribed by FAS2 (see above) would have solved the problem of accurately presenting the financial performance and status of firms in their reports. The reason it could not is that the real decisions managers, auditors, and investors make—the R&D outlays and valuation of the firm—depend on and interact with how they are accounted for. In contrast, the amount of gasoline one would buy at the pump and the amount paid hardly depend on whether the gas is measured in gallons or liters. At the gas station, all that matters is that the measure used is fixed and known to all; in accounting FAS2 is fixed and known to all but does not solve the problem of financial reporting.

The parallels between accounting and natural languages are close but are often misinterpreted. Communication is possible because the meaning of words is partially shared but is incompletely specified.[12] If a word (or accounting term) were to be defined with total

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right direction if this modification were made permanent to help competition between the two sets of standards persist.

12 See Kitchen (1954) and Fearnley and Sunder (2006).

precision, it would apply to but one specific object such as a particular copy of a particular book; the inevitable differences among various copies and various books would make it inappropriate to use the same word for them all. The usefulness of the word *book* calls for certain ambiguity in its meaning, so the boundaries among books, such as monographs, manuscripts, booklets, pamphlets, and e-books, remain a matter of judgment. The same is true of accounting terms. When the authority to write definitions resides in a single body, it inevitably faces endless demands for interpretations, clarifications, and guidance, which it accommodates by writing more detail into the rulebooks. It is hardly surprising that natural languages flourish in the form of social norms with the meaning of the words arising bottom-up through common usage. Authors of competing dictionaries document this usage and earn their authority and respect from being good at gathering and organizing such information. Pursuit of uniform standards written by authority at the expense of social norms[13] diminishes the effectiveness of financial reporting in stewardship and governance, and in better informing security markets.

Accounting is closely interlinked with the laws, social norms, and mores of a society. Even a cursory review of the history of accounting reveals how the sociopolitical–economic events and systems help determine the U.S. accounting. Examples of accounting for inventories using LIFO method (and the tax-book conformity requirement of LIFO) and accounting for deferred taxes readily come to mind as consequences of U.S.-specific factors. Validity of assuming that no such forces exist elsewhere in the world, or that they can be ignored in favor of written standards based on the practices of the English-speaking countries, or that the advantages of international coordination override the cost of abandoning the fit between accounting practices and local conditions, remains to be shown.

13 See Sunder (2005a, 2005b).

5. **This single set of standards should be practiced in the United States, European Union, and elsewhere, and the U.S. educational system should prepare itself to integrate IFRS into its curricula so U.S. graduates will be able to prepare, use, and audit financial reports based on IFRS.**

Although the attempts to write uniform standards of financial reporting are primarily driven by their direct and immediate impact on capital markets, they also have major educational consequences. It is possible to argue that these consequences are equally if not more important, and that they deserve more attention from academics and those charged with the responsibility to develop standards.

The expansion of the ambit of written authoritative standards has led to fundamental changes in textbooks, course content, classroom discourse, and examinations, including the professional examination for CPA certification. In the absence of an authoritative standard for a class of transactions, textbooks, class discussion, and examinations tend to explore various possible ways in which a transaction could be accounted for, consequences of alternative accounting treatments for various parties and the economy as a whole. Such a discourse helps develop students to think fundamentally and develop and exercise their judgment, instead of looking for black-and-white answers, and attracts young people with powers of abstraction to the accounting profession.

With expansion in the scope of authoritative standards, educational discourse has progressively shifted toward increasing emphasis on rote memorization of written rules to be regurgitated in the examinations. With the accounting standards written by the FASB being granted a monopoly status for public companies, intermediate accounting classes have moved toward focusing on line-and-verse application of those standards, and not on critical examination of the merits of alternative accounting treatments for various classes of transactions. In many schools, two terms are no longer sufficient to cover this expanding volume of material generating calls for more teaching resources.

It has been argued that competition among multiplicity of standards would call for even more accounting courses, core requirements, faculty, classrooms, and other academic resources, and tuition fees or taxes to pay for them all. Under the current system of accounting education, it is not reasonable to expect the students, who have been drilled to memorize the specifics of FAS to figure out by reading IFRS what they should and should not do. While accounting firms worry about additional costs of multiple standards and seek to economize by arguing for uniformity, some in academia see this as an opportunity for expanding accounting programs.

Alternatively, we could follow the example of law schools and consider moving the accounting educational system in the direction of teaching general principles and higher-level nonroutine skills that are largely independent of the specifics of the standards issued by one or another regulator from time to time. Students educated in such a higher-level system of education will have developed the powers of abstraction and independent critical thinking that would allow them to adjust to changes in standards and apply them to specific transactions using judgment developed through education in general principles. Even under this alternative, time and resources would be needed to reorient the accounting education system.

Juliet Cao of the University of Washington at Tacoma writes:[14]

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14 Personal correspondence.

> In short, I realize that it will really be useful if the students can walk away from the class knowing (1) what exists is not necessarily optimal; (2) what is hard to achieve is not necessarily undoable (e.g., introducing competition into standard setting); (3) that it is ultimately us, individual accounting professionals, who shape the whole industry. It is a pity that students are often drowned in technical details and instructors do not have enough time to expose them to more interesting and important aspects of accounting. This is especially true for intermediate accounting, as most students may plan to take the CPA exam and feel uneasy when the instructor deviates from the "must cover" list of specific topics because they might show up in the CPA exam.

In education, uniformity discourages thoughtful classroom discourse, attracts less talent to accounting programs and, ultimately, to the accounting profession. Uniform standards induce a follow-the-rule-book attitude among accountants at the expense of developing their professional judgment. Since judgment and personal responsibility are the hallmarks of a learned profession, pursuit of uniform written standards weakens the accountants' claim to belong in this class, as well as the claim of accounting degree programs to belong in universities alongside professions such as architecture, dentistry, engineering, law, medicine, and nursing.[15]

To conclude, finding a balance between uniform standards and norms, and defining the extent of their respective roles in financial reporting, are not easy tasks. Standard-setters find it difficult to know which standards are superior, and what should be the criteria for ranking the

15 For evidence on decline in accounting education in the U.S. universities and difficulty of attracting new talent into accounting PhD programs in face of aging faculty, see American Accounting Association (2005), and Leslie (2007, 2008).

alternative standards. Societies that depend on norms and tradition also can get stuck in inefficient solutions and it may take reform movements, even armed uprising, to release them.

By their nature, evolved social norms and culture are specific to the society they serve. Variations in evolved systems, such as in the beaks of the finches inhabiting various valleys of the Galapagos Islands, or in wedding ceremonies in various parts of the world, cannot be explained entirely in terms of identifiable factors. Random chance and history also play a role. Attempts to harmonize financial reporting across the world assume that all cross-country variation in financial reporting practices is random or at least that the advantages of dispensing with such variations exceed any reduction in the fit between the local economic environments and the financial reports. The practices proposed for universal use are those prevalent in the English-speaking countries, and their authoritative versions written down in English often have no exact equivalents in Chinese, Japanese, or even Italian and German.

The pendulum appears to have swung too far in the direction of uniform written standards. We should consider giving social norms a stronger role and restoring the role of personal and professional responsibility in accounting and business. We could use 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 cannot capture either of these ideas. It may be necessary to create some kind of accounting court system to judge what constitutes "fair representation," as Spacek (1958) proposed.

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, U.S. firms could be permitted to choose from a small set of standard systems selected by the regulators. 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 or on tax collection. With competitive standards, 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.

In the preface to his 1755 *English Dictionary*, Samuel Johnson wrote about his "fortuitous and unguided excursions into…the boundless chaos of a living speech." Can authoritative uniform standards without collaboration with social norms bring a semblance of order to the chaos to financial reporting? After seven decades of incessant efforts, it is clear that the current accounting consensus in favor of monopoly accounting standards will make things worse, not better.

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Appendix II:

Adverse Effects of Uniform Written Reporting Standards on Accounting Practice, Education, and Research[16]

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Abstract

When transactions have multiple attributes, achieving uniformity in their classification depends on whether similarities or dissimilarities are of interest; uniformity with respect to both is not possible. The pursuit of uniform written standards at the expense of social norms diminishes the effectiveness of financial reporting in stewardship and governance, and in keeping the security markets informed. A shift to written standards discourages thoughtful classroom discourse on alternatives which develop professional judgment. It also engenders "by the book" attitudes and drives talent away from accounting programs and, ultimately, from the accounting profession. Judgment and personal responsibility being the hallmarks of a learned profession, the dominance of uniform written standards weakens the claim that accounting programs belong in universities alongside architecture, dentistry, engineering, law, and medicine. Uniformity discourages research and debate in academic and practice forums and promotes increasingly detailed rule-making. It shuts the door on learning through experimentation, making it difficult to discover better ways of financial reporting through practice and comparison of alternatives. Improved financial reporting calls for a careful balance between written standards and unwritten social norms.

Keywords: Accounting standards, uniformity, profession, practice, education, research
JEL Codes: M41, M44

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Adverse Effects of Accounting Uniformity on Practice, Education and Research

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 Chairman, SEC

The pursuit of uniformity in accounting practice through written standards and their enforcement by authority has been a prominent theme in financial reporting during the past half-century. In the current decade, the convergence of accounting standards and the harmonization of accounting practice have been the policy of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). If the current trends continue, the U.S., the E.U., and many other parts of the world may claim to have reached this long-sought goal of uniformity in the foreseeable future.

The pursuit of uniform financial reporting through the official enforcement of standards written by organized boards enjoys broad support from government, business, the accounting profession, and academia. For evidence of this broad support, we can look at (1) practice: all four major firms have significant campaigns to promote IFRS for the sake of uniformity, (2) textbooks: the space given to written standards of financial reporting, (3) research: the number of papers in our journals concerning written standards, and (4) professional meetings: the number of sessions in the AAA’s professional meetings—the Anaheim meeting in 2008 had more than a dozen sessions on written standards. Further, noteworthy by its rarity in our discourse is mention of the role of social norms in accounting. The label of “generally accepted” in accounting and auditing is now claimed for "what is required at the threat of penalties." It is widely believed that uniform written standards will result in improved financial reporting; better governance and stewardship of business, not-for-profit, and governmental organizations;

and better informed and more efficient financial markets directing capital toward productive deployment. When accounting problems arise, we look to written standards to address them.

This paper presents a contrarian case: When transactions have multiple attributes whose similarities as well as dissimilarities are of interest, a uniform scheme of classification is not feasible. The pursuit of uniform written standards at the expense of social norms diminishes the effectiveness of financial reporting in stewardship and governance, and in keeping the security markets informed. Before the enactment of federal securities laws in the 1930s, social norms played an important role in accounting which has gradually diminished during recent decades. Accounting has dispensed with its equivalent of common law, discouraging thoughtful classroom discourse on alternatives that would help develop professional judgment, and inducing "by the book" attitudes that drive talent away from accounting programs and, ultimately, from the accounting profession. Judgment and personal responsibility being the hallmarks of a learned profession, the dominance of uniform written standards weakens the claim that accounting degree programs belong in universities alongside architecture, dentistry, engineering, law, and medicine. Uniformity discourages research and debate in academic and practice forums, and promotes increasingly detailed rule-making. It shuts the door on learning through experimentation, making it difficult to discover better ways of financial reporting through practice and the comparison of alternatives. Better financial reporting calls for a careful balance between written standards and unwritten social norms. Allowing several standard setting bodies to compete, under regulatory supervision, for royalties from those who follow their standards may help achieve such a balance.

The enthusiasm for the pursuit for uniformity to the exclusion of social norms should be tempered by the recognition of unintended consequences arising from the path regulators of financial reporting have chosen. Perhaps it is not too late to adjust our goals so we can improve financial reporting by seeking to balance written standards with the unwritten social norms of the accounting and business community. I address the nature of uniformity and the role of social norms, institutions, and law in accounting theory, practice, education, and research before turning to reforms that might help pave the way for better financial reporting.

1. Uniformity and Classification

Uniformity has long been the holy grail of rule-making in accounting.[17] Diversity in accounting practices invites criticism rooted in an intuitively appealing idea that if the accountants would treat similar transactions similarly, and different ones differently, financial statements would be more useful. Unfortunately, this is not true. The problem is that two events or transactions are rarely exactly identical or totally different. Close examination nearly always reveals some similarities as well as some differences between any pair.

Transactions come in limitless variety, and the accountant must classify and aggregate them into a manageably small number of categories. We can use one of the following two principles to classify any set of transactions into a smaller set of categories:

1. Treat any two transactions that have any differences differently.

2. Treat any two transactions that have any similarities similarly.

Superficially, the two criteria may appear to be the same, but they yield quite different results. By choosing one, one necessarily violates the other, giving rise to a fundamental difficulty in defining and attaining uniformity and comparability in accounting (Sunder 1983, and 1997, p. 143-4).

In applying the first criterion, each transaction, being different from all others in *some* respect, must be treated differently. This yields an unmanageably thick accounting rule book, with each rule being used for only one transaction. In effect, there is no categorization and no aggregation. Some may call this a system without rules or uniformity because no two transactions are treated alike. Others can, with equal justification, refer to the system as the ultimate in uniformity in the sense that two transactions must be exactly identical in all respects in order to

[17]**uniformity** "overall sameness, homogeneity, or regularity" (Random House Dictionary); "freedom from variation or difference, …consistency, sameness" (Webster's Revised Unabridged Dictionary); "a condition in which everything is regular and unvarying" WordNet 3.0; "adherence to an imposed regulation or established rule or custom" (Kohler's Dictionary for Accountants, 1983). Further, Kohler's Dictionary has an entry that anticipates the difficulties of attaining uniformity:

> **uniform accounting system** A system of accounts common to similar organizations, such as those developed or promoted by associations and those promulgated by federal and state regulatory bodies such as public utility commissions.
>
> Attempts to establish uniform accounting for an industry or for all forms of human endeavor have been unsuccessful, at least in the United States, because the principal objective has been the development of elaborate, categorical classifications of accounts designed to aid in making comparisons, or to facilitate the construction of macro statistics, whereas the aim in micro accounting has been to provide information peculiar to the self-contained, self-concerned organization or individual; information not readily adaptable, without substantial adjustment, to a macro buildup.

In the so-called "Norwalk Agreement" the FASB and the IASB committed themselves "to the development of high-quality, compatible accounting standards" without defining either "compatible" or "high-quality" (http://72.3.243.42/news/memorandum.pdf).

qualify for the same treatment. In a world where transactions have multiple attributes of substantive interest, pursuit of uniformity carried far enough leads to complete diversity.

Paradoxically, applying the second criterion does not help. If every pair of transactions that have anything in common between them are treated alike, then all transactions are covered by a few categories, or even a single one. In accounting, this is not of much use. This problem is common to all systems of rules and laws, as well as to other schemes of classification.

The point can be graphically illustrated by a simple example of four objects which differ in, say, size and color—two large, two small, two black and two white (see Panel A of Figure 1). Applying the first uniformity criterion to size (objects with any differences should be treated differently) we get the classification shown in Panel B. However, this classification would leave dissatisfied those who consider color to be the important criterion. Applying the first uniformity criterion to color, we get the classification shown in Panel C, which would leave unhappy those people who consider size important. It would seem that there is a simple solution that would make them both happy: apply the first criterion to both size and color, and we get the four-way classification shown in Panel D.

However, D is far from perfect when we look at the second criterion of treating similar transactions alike. This four-way classification leaves one to wonder why two objects which are both black are being treated differently, and why two objects which are both large are being treated differently. In short there is no conceptual way, even in a simple theoretical example, of satisfying the uniformity criterion in a world in which more than one attributes of objects, transactions, or events are important to the users of financial statements. In practice, things get even more complicated.

The accounting treatment of research and development (R & D) outlays is a case in point. Until the FASB issued FAS 2 in 1974, capitalization of these outlays was left largely to the discretion of management. Practices varied across firms. Demands for uniformity led the FASB to search for rules that would reduce management discretion in capitalization decisions and closely approximate the economic substance of these events. It soon became evident that there was no way of satisfying both of these requirements. The nature and circumstances of research and development outlays, and their results, vary so greatly that it is not feasible to lay down rules that will remove management discretion without also weakening the link between the economic consequences of R & D outlays and their accounting treatment.

The FAS 2 removed managers' discretion by requiring that these outlays be expensed. It achieved uniformity of form, not substance. The underlying event that is supposed to be recorded is not the R & D expenditure alone, but also its economic consequences. Expensing all R & D outlays, irrespective of the results, creates a greater divergence between the underlying event and its accounting treatment than might occur under a discretionary system. Two firms, each having spent $10 million on research, will have identical financial statements, irrespective of the development of a hot-selling product by one of the firms. Whether FAS 2 has led to greater uniformity of financial statements in this fundamental sense is questionable.

To summarize the first main point, there is no conceptual way of defining the uniformity criterion that can help guide standard setters, preparers or auditors in improving financial reporting. Concepts such as uniformity, comparability, and compatibility, often used interchangeably, are operationally vacuous for accountants' work.[18]

2. Written Standards versus Social Norms

Norms of a social group can be defined as the common-knowledge expectations of its members about how they and their fellows should behave in various circumstances.[19] Wearing a coat and tie in an office is its social norm if, even in the absence of any formal rules and enforcement processes, and in the presence of available and convenient alternatives, men do in fact wear coats and ties and expect others to do the same. In this sense, social norms or conventions are indistinguishable from the culture of the group (Sunder, 2002c, 2005a,b).

Unlike formal rules and regulations, motivation to conform to social norms is rooted in the anticipation, or even fear, of embarrassment and others' disapproval of deviations from the norms. Social norms may be so internalized by individuals that conformity may be seen as a moral or ethical obligation. When norms become sufficiently internalized, the members of the group may find it redundant to monitor conformity, giving rise to trust. The key mechanisms that create trust in society are personal relationships and the social embeddedness of market participants rather than the legal rules and the formal enforcement structures.[20]

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[18] "[T]"… the Boards (FASB and IASB) reaffirmed their commitment to the goal of convergence. In doing so, however, they again rejected the dictionary definition of convergence, moving toward union or uniformity, as an end in itself, agreeing instead to focus on convergence as described in the 2002 Norwalk Agreement—the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting" FASAC (2005).

[19] Common knowledge of X, in its technical meaning, is shared knowledge among two or more people such that each knows X, knows that others know X, knows that everyone knows that everyone else knows X, ad infinitum.

[20] See Cook (2001) on the role of trust in society.

It has been a long time since accountants began to shift their allegiance and attention away from norms. Today the authoritative promulgation of accounting standards is often assumed to be synonymous with progress. It is easy to identify the history of accounting principles with organized efforts to produce written rules, because documentary traces of such processes are readily available to the historians. On the other hand, even widely accepted social norms leave nary a footprint in the public record. We can see the evidence of norms in fiction[21,22]. Unfortunately, accounting is hardly a favorite subject in English literature, or in the literature of any other language, for that matter.

The early predominance of norms is clear from 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 reprint of a memorandum on auditing procedures, prepared by the American Institute of Accountants, approved by the Federal Trade Commission (FTC), and originally published in the Federal Reserve Bulletin, was 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 behind this effort was to coordinate the evolution of accounting norms and not to impose a standard.

In the same year, 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 recommended against the inclusion of imputed interest in the cost of production, and this recommendation was approved at the annual meeting of the Institute. Nonetheless, the recommendation failed to win acceptance as an accounting norm.

[21] For examples of accounting and commerce in Chaucer and Goethe and other German literature, see Russell (1986), Gallhofer and Haslan (1991) Jackson (1992), Ganim (1996), Maltby (1997), Parker (1999), and Evans (2005).
[22] Waymire (personal communication) suggests that researchers have rarely ventured to examine the internal correspondence and discussions of client and audit firms where they might find the "footprints" of social norms.

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. Zeff discusses several active mechanisms that the accountants of the day might have used to develop and identify the norms of their profession. Pages of the 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 accounting journals over the past quarter century as authoritative standards gradually displaced the norms in discourse and practice. During 1920-29, the Librarian of the Institute issued 33 "special bulletins" on topics referred to them, albeit 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.[23]

The stock market crash of 1929, and the economic depression that followed, also precipitated a crash in the trust in norms of accounting and the formal and informal mechanisms by which these norms evolved and were sustained. The social contract was broken. Government responded to the economic crisis by introducing securities laws, creating the Securities and Exchange Commission and its regulations to replace the norms and private innovation. In the following seven decades, accounting and audit failures came to be interpreted as evidence that norms do not work. Norms were gradually shifted to the back burner, and legislated accounting standards rose to dominate accounting.

The shift is also reflected in the increasingly assertive nomenclature of the three private sector institutions created to write accounting rules, and how they labeled their pronouncements: The Committee on Accounting Procedure's *Accounting Research Bulletins* (1939-59), the Accounting Principles Board's *Opinions* (1959-73), and the FASB's *Financial Accounting Standards* (1973 to present). The IASB's *International Financial Reporting Standards* are the latest addition to this regulatory trend. Grady's *Inventory of Generally Accepted Accounting Principles* (1965) and the 62 volumes (from 1946/47 to 2008) of American Institute of CPAs' annual survey of the financial reporting practices of some 600 organizations under the title *Accounting Trends and Techniques* are examples of the attempts to support the evolution of social norms of accounting. Has the increased assertiveness of written rules, and the confidence they imply in the ability of corporate entities such as standards boards to devise better methods of accounting been justified by their actions?

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[23] In his review of *Costing Terminology,* Kitchen (1954) provides a masterful argument for resisting the temptation to issue official definitions, especially in accounting. See also Baxter (1953).

2.1 Accounting Institutions

Written standards with formal enforcement are concrete and salient. Standards are published, easily disseminated, specified formally with some precision, and can be cited, analyzed and discussed chapter and verse. They come into existence at a specific time, through a known and well-understood institutional process that may allow the constituents to participate. When the environment changes or the standards are no longer perceived to induce the desired patterns of behavior, a systematic process is available to formulate changes and submit them to a well-specified process for possible promulgation.

A transparent institutional mechanism for setting and modifying standards holds a natural appeal in a democratic polity. Following accidents and scandals, "the rules were not clear," is a popular defense for scoundrels and managers who have not adopted good data-handling practices. Codification of standards—let us make the rules clear to all—is a frequently chosen response to calm the political waters.[24] Formal written standards also appeal to our sense of good housekeeping.

Social conventions and norms are less well defined, vary in time and space, and require extended socialization to learn and understand them.[25] Conventions carry a penumbra of uncertainty about the edges; there is substantial but incomplete overlap among the beliefs of the individual members of a group about its norms. Even with a unique definition in time or place, norms evolve in small, almost imperceptible steps, by processes that are neither observable nor well understood. The evolution of norms is decentralized in the extreme, and even experts find it difficult to know which rules or practices are better, and to predict their 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 and crises, when they occur, make a mockery of the claims of expertise and efficiency required to legitimize existing institutions. It is hardly surprising, then, that during periods of crisis, political or bureaucratic decision makers feel pressure to displace markets and social processes and write new standards instead of relying on existing (recently discredited) norms and business practices.

[24] In response to William Z. Ripley's Atlantic Monthly (September 1926) article, "Stop, Look, Listen!" accusing large corporations of dishonest and deceptive financial reporting practices, even George O. May said: "… it seems to me that the extension of the independent audit, accompanied by a clearer definition of the authority and responsibility of auditors, is one of the most valuable remedies to be found for the defects of which Professor Ripley complains."…". May was an influential leader of the U.S. accounting profession and, as indicated in the opening quote, generally seemed to favor norms over standards.

[25] See Fuller (1964) and Dworkin (1986) for a discussion of natural law theory, Hechter and Opp (2001) for an overview of the sociology of norms, and Coleman (1990) on social conventions.

There is also a fundamental weakness in the structure of a standard-setting body. A permanent rule-making bureaucracy must produce rules in order to justify its budget and existence. If the making of rules is their only responsibility, should we not expect them to write new rules and, inevitably and routinely, add to the thickness of the rulebook with the passage of time? Until its public financing by the provisions of Sarbanes-Oxley Act of 2002, the FASB was dependent on the sale of its publications for a significant part of its revenue. The rule of "publish or perish" is as true for rule-makers as it is in academia.

Another consequence of having institutions with rule-making as their sole function is that their very existence invites and encourages requests for clarifications. Clients ask their auditors 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 allowing 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. The existence of standards boards promotes an attitude of, "if it is not prohibited, it must be permitted." 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 redesigned to get around the rules and to frustrate the intent behind them.

3. Law and Social Norms

Legal scholarship and practice carefully 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 leaves the judgment in place, irrespective of the importance of the question at hand. When a judge asks the jury to determine if the accused is guilty beyond reasonable doubt, jurors want to know how much doubt is reasonable: ten, two, or one percent? The law does not attempt to codify answers to such questions. Legislators and lawyers understand all too well the consequences of clarifying such questions can be even less desirable than the consequences of leaving them to judgment, even when the judgment is exercised by lay people. Similarly, the U.S. Securities and Exchange Commission (SEC) and Congress refuse to clarify the definition of insider trading beyond "trading on non-public information." The consequences of writing clarifying rules to specify what constitutes non-public information are even less desirable than the consequences of leaving such matters to the ex post judgment of investors and the enforcement and judicial systems.

Accountants, on the other hand, have been willing to pursue uniformity through endless clarification of written accounting rules, to the point of defining the percentage thresholds for materiality, lease capitalization, consolidation of subsidiaries and special purpose entities, etc. With such written standards in place it is child's play for the Wall Street bankers, accountants and lawyers to design transactions and financial instruments to frustrate the intent of the standards, no matter how carefully they have been drafted. Setting up accounting institutions whose sole function is to issue new accounting rules, contributes to the tendency to write standards which are "generally accepted" only in the sense of "follow them, or else." Accounting could borrow some wisdom from law, remove the monopoly jurisdictions of rule-makers, and introduce elements of regulated competition (discussed in Section 6) among rule makers within each financial reporting jurisdiction in order to avoid this problem (Dye & Sunder, 2001; Sunder, 2002a, 2002b, 2009).

4. Practice

In practice, there are five reasons as to why attempts to create a uniform set of top-down, written standards do not necessarily dominate social norms in financial reporting. I discuss them as information, design, gaming, signaling, and clarification problems.

4.1 The Information Problem

Rule makers face a difficult problem in identifying better rules. One can appreciate this challenge by asking a simple question: what is a good rule for determining pass interference in a game of American football? Rules can affect different members of society (and players in a game) in diverse ways. The direct effect of the rules on people depends on their individual circumstances, of which the rule maker can have only limited knowledge at best (see Hayek, 1945). Rules are designed in the hope that they will change or constrain the behavior of at least some people; however, changes in individual behavior interact in complex ways, generating aggregate consequences that are difficult to anticipate. The rule maker may try to ameliorate this inherent informational disadvantage by soliciting information from the parties potentially affected by its actions. Unfortunately, these parties have little incentive to report truthfully. Their strategic responses muddy the waters (see Sunder, 1997, Chapter 11, and Sunder, 2003), create the gaming problem discussed below, and thus often force the rule maker to deal with unintended consequences of the rules. Since they evolve over longer intervals of time, through trial-and-error, social norms can incorporate more information the rules made by legislature, boards, and other corporate entities usually can.

4.2 The Design Problem

Corporate, standard-setting entities need structure, people and resources. All three requirements necessitate compromises in the design of the entity. Legislative structures emphasize representativeness; judicial structures emphasize impartiality, while bureaucratic structures value rules of procedure above all. It is difficult to attain representativeness, impartiality, and consistency of procedure all at once in a single institutional structure (Sunder 1988).

Finding people to operate the rule-making system raises parallel problems. The best experts may not be representative or impartial, and they may be inclined to use their judgment instead of following pre-defined procedures. Representative bodies may lack expertise in the substance of the matter, and may not place impartiality high on their agenda, and so on. Finally, those who pay for the cost of developing uniform standards understandably seek to further their own agenda through their influence over the finances of the standard-setting entity. Such inevitable compromises distort the functioning of standard-setting bodies.

In contrast, the gradual evolution of social conventions—a mass phenomenon—is less susceptible to these weaknesses of corporate entities because such entities do not play a major role in the process.

4.3 The Gaming Problem

The difficulty posed by the information problem discussed above is compounded by the dynamic interaction between rules and the behavior that the rules are devised to influence. Each standard affects the decision environments of the relevant individuals by changing their opportunity sets and payoffs, and at least potentially alters their decisions. The rule makers, with limited information, cannot anticipate all such changes, and the rules therefore often lead to unintended consequences in the form of individual behavior and their social outcomes. For example, Tan and Jamal (2006) found that reducing discretion in accounting rules has an unintended effect of changing the “real” operating decisions of managers. Any adjustment of the rules to such outcomes sets up yet another cycle of adjustments and changes. Individuals can adjust faster than the rule makers can. It is difficult to make sure that this action-reaction sequence converges to a stable pattern of behaviors which are in mutual equilibrium, and that this equilibrium is Pareto superior to the status quo (i.e., it makes at least some people better off without making anyone worse off).

4.4 The Signaling Problem

A uniform standards approach to financial reporting favors narrowing the range of options available to the reporting entity and foregoes a valuable signaling opportunity. Many believe that narrowing the set of choices available to an accounting entity in how to report a given event or transaction promotes comparability and consistency and enhances the informativeness of financial statements. This argument ignores the signaling value of the choices made by the reporting entity. In making a choice from a given set of alternatives, the entity cannot help but reveal some information about its preferences and expectations. Managers of the entity reveal their privately held information, in part, through the financial reporting methods they choose (Dye 1985 and Levine 1996). The use of aggressive reporting methods gives valuable information to careful readers of the financial reports about how hard-pressed the managers of the firm are. Narrowing financial reporting choices through uniform standards curtails the ability of managers to transmit information through their choice of financial reporting methods. This signaling aspect of financial reporting has received little attention in the setting of accounting standards.

Under social norms a broader range of behavior remains permissible and acceptable. The more tightly specified the school dress code, the less one can learn about individual children from their appearances in the playground; without choice and self-expression, less information is available to others. Morison (1970, p. 281) wrote:

> The power of free and rational argument remains, I am old-fashioned enough to believe, the best road to the truth in human affairs. I would therefore give companies the maximum freedom to present their accounts in whatever way they thought fit, and would then require them to explain and justify the course they had taken. The auditor's task—no light one!—would be to ensure that they did. And to see they did it fairly.

I do not suggest going so far as to give companies "the maximum freedom," but allowing them a choice among a small set of carefully chosen competing standards would be helpful.

4.5 The Clarification Problem

Since the collapse of Enron and WorldCom in 2001, accounting discourse has been dominated by claims that (1) there is a distinction between rule-based and principles-based standards of accounting, and (2) the former is exemplified by the FASB's approach and the latter by the IASB's. The appeal of this distinction rests on the longing for the simple idea of fewer, more general standards that leave details of implementation to individual judgment, as opposed to more detailed standards that try to get into more specifics of implementation. This longing manifests itself in periodic calls for simplification of financial reporting rules from preparers, users and regulators. Unfortunately, it is rooted in an inadequate understanding of the dynamics of standardization.

The location of standards on the generality-specificity axis is driven not by the ex ante choice of the Boards but the supply and demand for specificity, history, and the alternatives available to various participants. Most standards, rules and regulations, in accounting and elsewhere, are born small. They grow over time, not because standard setters prefer to add the details, but because earlier versions generate requests for clarification that arise from conflicting interpretations rooted in the self-interests of those who implement the standards. Requests for clarification present standard setters with a dilemma between keeping things simple (and asking people to use their own judgment in implementation), and providing clarifications and guidance which inevitably call for more detail.

If standard setters ask for the use of judgment, they risk appearing to be unresponsive to constituents. This may undermine their legitimacy, especially if they are in the private sector. Use of judgment also promotes diversity in practice, which undermines the presumed goal of attaining uniformity and comparability through standardization. On the other hand, clarification and guidance is an endless process of growing detail.[26] In spite of the best intentions of standard-writers to stick to principles, over time, their work accumulates to form ever larger volumes. Therefore, the difference between principles-based and rules-based standards is not a matter of the intent of the standard setters, but the point at which they stand in this dynamic process. IASB, being a more recent entrant in the game, is in an earlier stage of the same process than the FASB. Its recent struggles with its so-called "fair value" accounting standard is an illustration of how similar processes tend to lead us to similar outcomes, regardless of the intent of a standard-setter to stick to principles.

The information, design, gaming, signaling, and clarification problems are ever-present in setting standards; they deserve consideration when we weigh the roles of uniform standards and norms in financial reporting.

5. Education and Research

While the attempts to write uniform standards of financial reporting are primarily driven by their direct and immediate impact on capital markets, they also have major educational consequences. It is possible to argue that these consequences may well be more important for welfare of society, and they certainly deserve more attention from academics. Moreover, those charged with the responsibility to develop written standards should include the educational consequences of their actions in a part of their deliberations.

The expansion of the ambit of written authoritative standards has led to fundamental changes in textbooks, course content, classroom discourse and examinations, including the professional examination for CPA certification conducted by the AICPA. In the absence of an authoritative standard for a class of transactions textbooks, class discussion, and examinations explore various possible ways in which a transaction could be accounted for and the consequences of alternative accounting treatments for various parties, and for the economy as a whole. Such discourse develops the minds of students to think fundamentally. It does not allow for black-and-white answers and it helps attract abstract thinkers to the accounting profession. The exercise of judgment is a hallmark of a profession.

With the expansion of the scope of authoritative standards, educational discourse has progressively shifted toward the rote memorization of written rules that must later be regurgitated during examinations. With the accounting standards written by the FASB/IASB being granted a monopoly status for public companies, intermediate accounting classes have moved toward focusing on a chapter and verse application of those standards, and not on critical examination of the merits of alternative accounting treatments for various classes of transactions. Instructors of accounting who try to develop the analytical powers of their students face inordinate pressures to "cover" the expanding volume of written standards. Since time is limited, what is written and definite takes priority over unwritten norms and the development of subjective judgment. Such a "memory-based" curriculum tends not to attract talented youth to a profession, nor to retain their interest for very long. Indeed, few other learned professions rely on standards to the extent that accounting does.

A second aspect of the problem is educational capacity. Under the current system, college and university courses in U.S. spend much time and course work teaching the specifics of accounting standards. It has been argued that competition across a multiplicity of standards would call for even more accounting courses, core requirements, faculty, classrooms and other academic resources, and tuition fees or taxes to pay for them all. Under the current system of accounting education, it is not reasonable to expect students, who have been drilled to memorize the specifics of FAS, to then read IFRS and try to figure out what they should and should not do. While accounting

[26] U.S. Sarbanes-Oxley Act of 2002 and the Public Company Accounting Oversight Board's detailed approach on corporate internal controls and governance stands in interesting contrast to the comply-or-explain approach used in the United Kingdom under the Combined Code issued by Financial Reporting Council.

firms worry about the additional costs associated with multiple standards and seek to eliminate them through the adoption of uniformity, some in academia see this as an opportunity for expanding accounting programs.

Alternatively, we could consider moving the accounting educational system toward teaching general principles, which are largely independent of the specifics of the standards issued by one or another regulator from time to time. Again, we could take as our inspiration the practice of law schools, which focus on common fundamentals of property, contract, tort or legal procedure without trying to teach the statutes of the fifty states. University education, whether in law or accounting, is more appropriately concerned with the teaching of fundamentals, rather than focusing on the specific details of myriad statutes, which a practitioner can read up on when he or she moves from one state jurisdiction to another.

Students engaged in such a high-level system of education develop powers of abstraction that allow them to pick up any system of standards and apply it to specific transactions, using their own judgment based on an understanding of general principles. Given that intermediate accounting courses and textbooks have already become predominantly oriented to rote memorization of standards, even this alternative would require time and resources in order to reorient the accounting education system.[27]

The reliance of financial reporting on written standards and their convergence in the U.S. and the world does not hold the promise of a place for accounting in university-based, professional education. Such reliance does not help attract people who are willing to think, develop and use their judgment and take personal responsibility and earn the rewards that go to professionals who are willing to do so. Instead, accounting may be headed for the low road. We should not be surprised if the better business students begin to shy away from accounting after the SOX-induced bubble in the demand for accountants subsides. A shift of accounting practice from written standards toward social norms may help improve accounting education.

6. Thinking Reforms

Countries and economies vary in their social, economic, legal and commercial structures. Social norms play important roles in all aspects of society, evolve locally, and necessarily vary across the world. The idea of using a universal set of accounting standards to yield comparable financial reports is based on three fallacies: (1) a single set of standards is best for all economies; (2) a single set of standards applied across all economies will yield same

[27] See personal correspondence from Professor Cao of the University of Washington in the Appendix.

results; and (3) by making this uniform set of standards principle-based, financial reports generated across the world will be more comparable.

No single rule is ideal for all, except by rare coincidence, because the relevant economic, legal and social conditions vary. If the network externalities are sufficiently large, it may be possible to find a single rule that will be advantageous on average, even though it imposes net costs on some. However, it is not easy to find such a rule except through extensive experimentation, and there is no guarantee that, as prevailing conditions change, such a rule will remain advantageous even on average.

Financial reports are the result of a combination of economic and financial conditions and events on one hand, and the applicable financial reporting rules on the other. Even if the same rule is applied to all firms in all industries and countries, the characteristics of the results will vary, depending on the economy in which the firms operate. Thus the comparability of financial reports cannot be taken for granted even if they are prepared using the same set of rules.

Principles-based standards allow more room for the individual judgment of those who prepare and audit the financial reports. Individual judgments, independently applied to the events and transactions at hand, will vary. Thus, the greater the movement toward general principles in specifying the financial reporting standards, the greater will be the diversity of interpretation, and the lower will be the comparability of financial statements. The proposition that the application of principles-based standards across the world economies will result in more comparable financial reports remains to be supported by logic or data.

The monopolies in the U.S. and the EU deprive 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 a better method exists or can be devised. 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? The current preference for uniformity stands in the way of the evolution of accounting, denying accountants the right and opportunity to develop new and better methods.[28]

We should assist the evolution of accounting norms by allowing regulated competition among multiple accounting rule makers who neither collude nor consciously try to get their rules to converge. Instead of being forced to use either the FAS or IFRS alone, what if each U.S. firm could choose to use one of these two sets of standards? Standard-setting bodies could earn their revenue solely from the royalties charged for the use of their standards. Subject to light regulatory oversight, their financial viability will depend on how well their rules are able to balance the social norms and economic interests of thousands of managers and investors, as judged by their own actions. Regulatory competition prevails and works well in many domains, including corporate charters in fifty states, bond rating agencies, and higher education. For example, Jamal et al. (2005) examined the assurance seal market for privacy in e-commerce and found that the competitive regime in U.S. provided better privacy than the stricter regulatory regime of the European Union.

It has been argued that a competitive regime for accounting standards may allow, even encourage, a race to the bottom through regulatory arbitrage by managers of firms who are driven by narrow self-interest to paint a rosy picture of their performance to the public.[29] Such arguments incorrectly assume that the countervailing forces that act to deter rule makers from racing to the bottom are absent. First, it is in the interests of vigilant analysts and investors to identify the firms that choose standards which are inferior from their point of view, demand a higher rate of return from such investments, or withdraw their capital from them. The tendency of rule makers to slide into excessive details through successive clarifications and guidance would be counter-balanced by the reluctance of managers to subject themselves to tight straight jackets, and of investors to wade through the resulting complexity. The top-down insights of expert rule makers would be counter-balanced by the bottom-up "wisdom of the crowds" (see Plott and Sunder 1988, Surawiecki 2004). The monopoly power granted to the rule makers under the current

[28] See Stigler (1971) on risks associated with regulation, and Romano (2002) for arguments on a competitive system of laws for securities regulation.

[29] See FASB (2009, pp. 8-9): "Messrs. Linsmeier and Siegel believe that there are potentially other issues to address with the current other-than-temporary impairment model. However, they would prefer to address those concerns in the joint medium-term project with the International Accounting Standards Board (IASB). They believe that risks are high that a unilateral change to the recognition and presentation of other-than-temporary impairments could create the opportunity for an "accounting arbitrage" with pressure for FASB and IASB standards to converge to the standard perceived most lenient. In addition, changes by one standard setter acting on its own fails to achieve convergence of accounting standards, which continues the challenges faced by investors in comparing global financial institutions reporting under two different accounting models."

regime is also a burden which weakens their ability to stand up to unreasonable pressures from politicians and business interests. Under a competitive regime, such pressures would be counter-balanced by the rule-makers' ability to stand their ground, and they would direct the disgruntled to the alternative standards that are available across the street. Instead being the first step to deal with the problems of accounting when they arise, intervention by the regulatory authority would be taken as a last resort.

The regulatory arbitrage argument against competition ignores many important examples of regulatory competition, with no sign of a race to the bottom. In the U.S., competition among the fifty states for corporate charters exhibits no evidence that the small state of Delaware, which holds the lions share in this market, has done so by offering lenient conditions to corporations. A competitive system would facilitate the discovery of better accounting systems through experimentation and comparative assessment over time, without eliminating the important roles of judgment and social norms.

7. Concluding Remarks

Finding a balance between uniform written standards and social norms, and defining the extent of their respective roles in financial reporting, are challenging tasks. Both approaches have limitations. Standard setters find it difficult to know which standards are superior and what criteria to use for ranking the desirability of alternative standards. Societies that depend on norms and traditions also can get stuck in inefficient solutions (e.g., slavery), and it may take reform movements, even armed uprising, to release them. In accounting, we should avoid the mistake of relying on one or the other, because neither alone is unlikely to yield satisfactory results.

During the recent decades, the pendulum appears to have swung toward uniform 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 itself 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. Since written standards alone cannot capture either of these ideas, Spacek (1958) proposed an accounting court to judge what constitutes "fair representation." It is time to devote some careful attention to the idea.

Is it possible to tame the financial reporting practices of corporations through substantial, if not exclusive, reliance on uniform written rules and punishment for violations? While the standard setters erect short sections of fence in the vicinity where the lion was last spotted, the compensation committees of the boards offer the red meat of juicy compensation packages contingent on measured performance, encouraging hungry animals to walk around the flimsy standards barriers in the open jungle of financial reporting. A body of evidence on behavior of social animals suggests that, beyond their physical needs, constraints and threats, the norms of their society play a significant role in what they do. Perhaps it is not unreasonable to think that, given the importance of our own extensive and complex framework of social structures and norms, ignoring them may not be an effective approach to restore a semblance of order to the chaos of financial reporting.

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Figure 1 Panel A: Four Objects with Two Properties (Size and Color)
(Two Large, Two Small; Two Black, Two White)

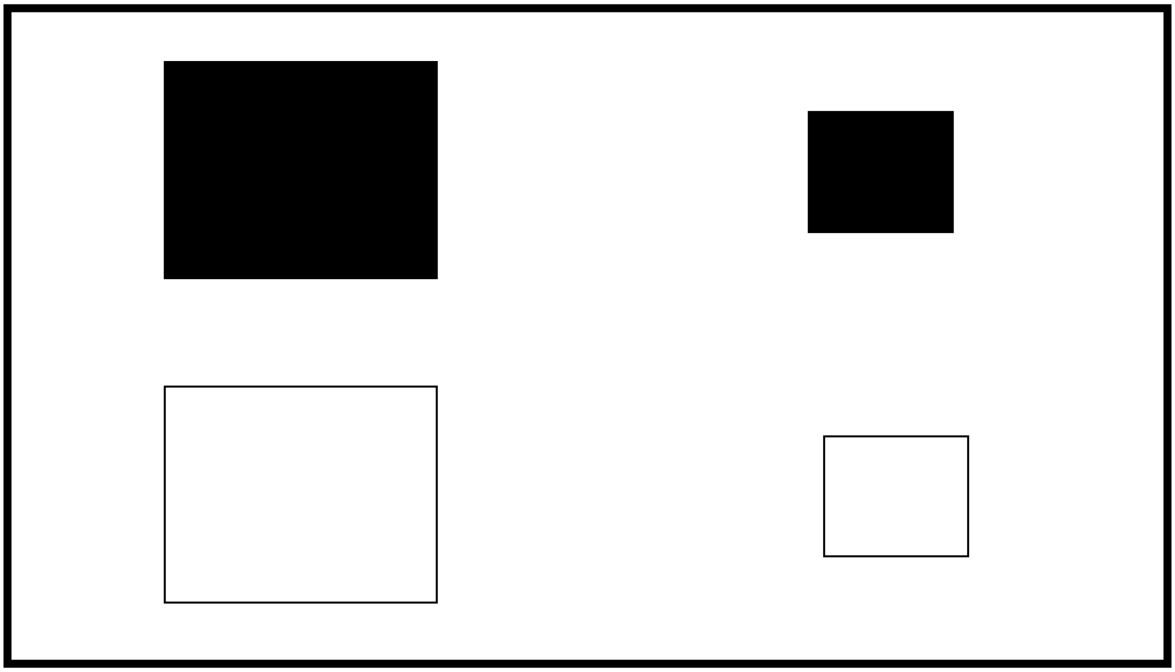


Figure 1 Panel B: Classification of Four Objects by Size
(Two classes, large objects in one class, small objects in the other)

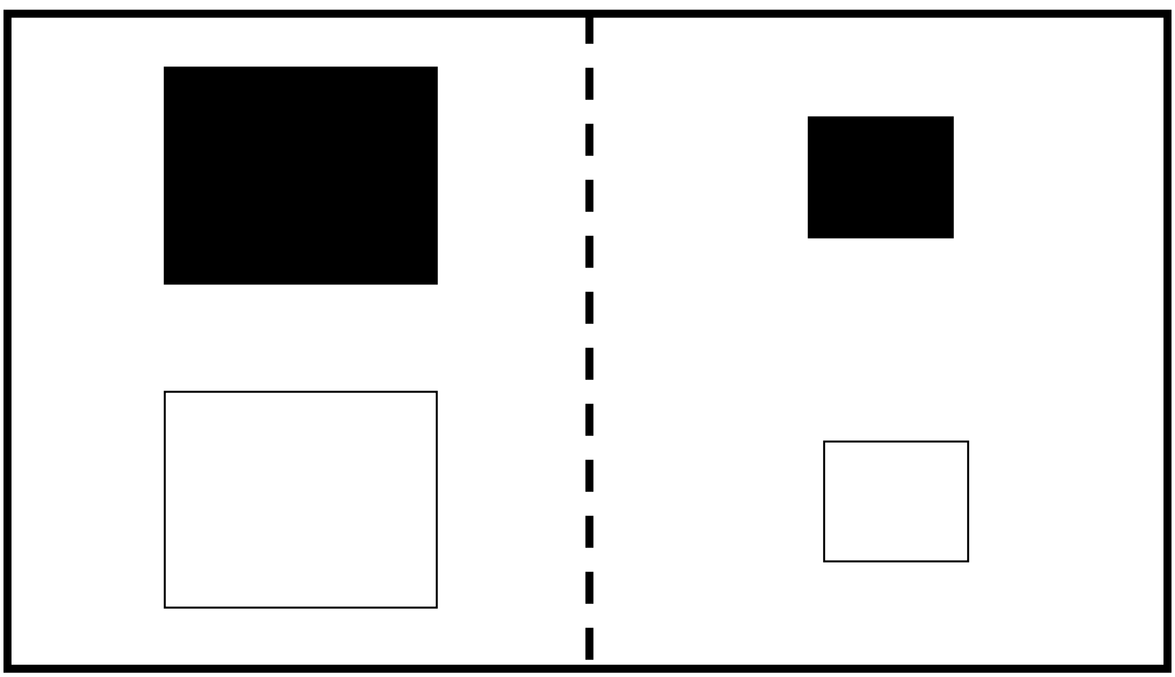


Figure 1 Panel C: Classification of Four Objects by Color
(Two Classes, black objects in one class, white objects in the other)

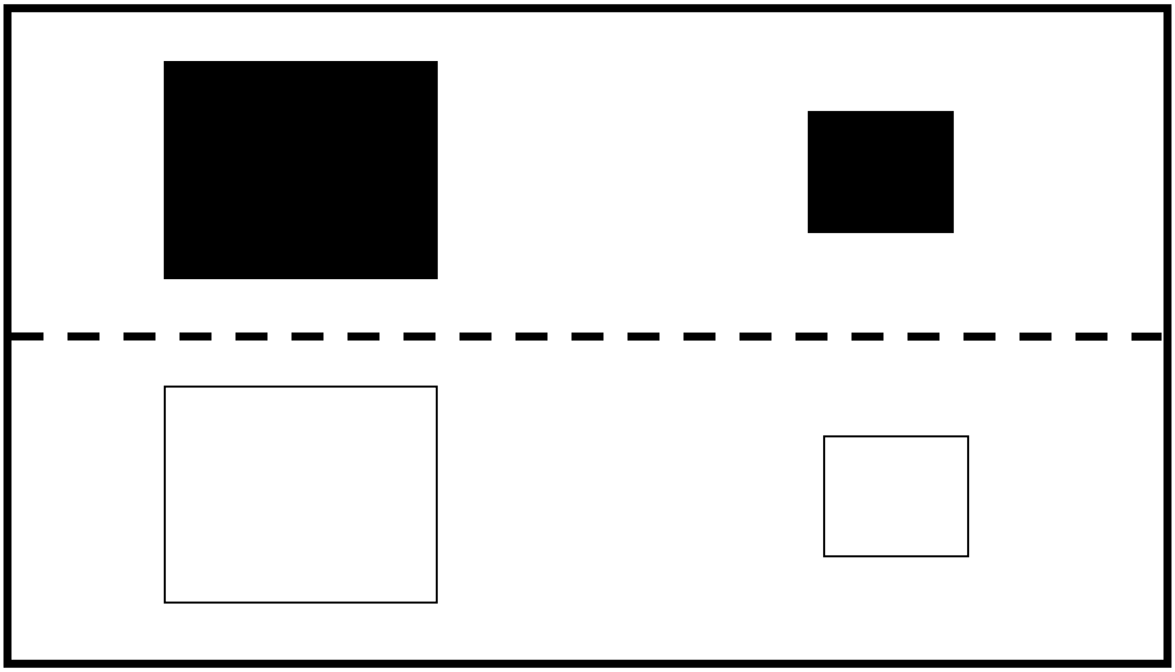
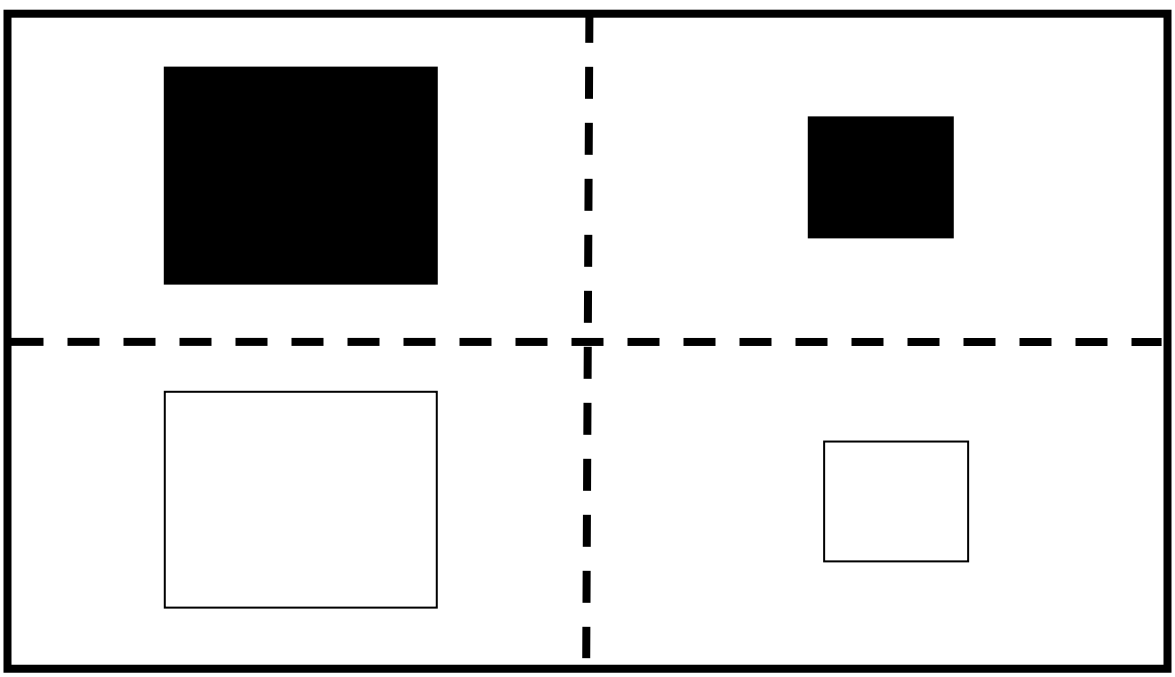


Figure 1 Panel D: Classification of Four Objects by Size *and* Color
(Four classes for large black, small black, large white and small white objects)



Appendix: Zhiyan (Juliet) Cao's Note on Teaching Accounting

(Personal Communication, Reproduced with Permission)

I taught three sections of Intermediate Accounting III at UW-Tacoma this spring. The students had diversified backgrounds with a combination of full-time college students and working professionals in part-time program. We used Intermediate Accounting by Kieso, Weygandt and Warfield (12th edition) as our textbook. The topics covered in this third intermediate accounting course include investment, revenue recognition, taxes, pensions, leases, cash flow statement, accounting for changes & errors, and full disclosure.

The greatest challenge was accounting for pensions. SFAS 158 had not been published in time for the 12th edition of the text and was not included in it. The pensions chapter had been organized using the off-balance-sheet approach, showing where pension liabilities and assets as memo records in the notes to financial statements. SFAS 158 moved everything to the balanced sheet, made the liability transparent, and the tricky and counter-intuitive minimum liability test unnecessary.

For me as in instructor, the major challenge of teaching pension accounting after SFAS 158 did not lie in the additional preparation for the lectures. As business environment changes, one should expected changes in accounting standards. Instead, my concern is that the new standard completely overturned the earlier approach to accounting for pensions. Students found this switch to a drastically different view of assets and liabilities disconcerting. Were the standards so radically wrong before? If so, why? Has the FASB changed to something which is really better? Will it help to have both methods around for a while and learn from experience which one is better? The only good thing about experiencing a big transition in standards while the students are learning the topic is that they start to get a better understanding of different forces that may have shaped FASB's decision and will perhaps think more independently and critically in the future.

It amazed me how many rules I am supposed to cover in the course, allowing less time for the big picture. With so much material to memorize, students ask for open-book exams/tests—not because they prefer opened-ended questions typical of open-book exams, but because they hate all the devilish details. By agreeing to an open-book exam, the instructor becomes a party to reinforcing the stereotypical image of accounting as being detail-oriented and boring. Whenever they could get the opportunity, students loved to debate accounting policies in the class.

For example, last month FASB came up with a cash flow statement-like format to break down net income into three components tied to operating, investing, and financing activities. Since I was teaching cash flow statement at the time, I devoted another half hour to discuss this new approach. Students start from the premise that if the FASB proposes something, it must have merit, and most of them supported the new approach. When I asked them if managers are the same people with same compensation contracts and same incentive to manage three components, they came up with many downsides of the new proposal.

Along the way, I asked them to think about principle vs. rule-based standards, competition in accounting standard setting, etc. I was amazed to see that when exposed to think for themselves, undergraduate students are as creative and insightful as doctoral students. I found it important to make the students believe what they do can have a positive impact on the industry. While I discussed accounting for investments in the class, the Wall Street Journal published an article about FASB's 800-page guidance on accounting for derivatives. It pointed out that managers tend to push the FASB for specific rules/guidance when a principles-based standard is issued. I asked the class what they would do when faced with a standard that allows room for their independent judgment in its application. After some heated discussion, they were began to see that the industry shares the blame for the increasing complexity of accounting rules with the SEC and the FASB.

In summary, it will be really useful if the students can take away three ideas from the classroom: (1) what exists is not necessarily optimal (e.g., the FASB setting everything for us); (2) what is hard to change is not necessarily undoable (e.g., introducing competition into standard setting); and (3) it is ultimately us, the individual accounting professionals, who shape the whole industry. It is a pity that students are so often drowned in technical detail that instructors do not have the time to expose them to more interesting (and important!) aspects of accounting. This is especially true for intermediate accounting. Most students plan to take the CPA exam and feel uneasy when the instructor digresses from the specific "must-be-covered" topics that may show up in the CPA exam.