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## **Rethinking Financial Reporting: Standards, Norms and Institutions**

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# Contents

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|          |   |           |
|----------|---|-----------|
| <b>1</b> | <b>Introduction</b>   | <b>3</b>  |
| 1.1      | Attributes, goals, and practice . . . . .                                 | 3         |
| 1.2      | Perspectives by time scale . . . . .                                      | 5         |
| 1.3      | Rules and institutions . . . . .  | 6         |
| 1.4      | Social norms . . . . .  | 7         |
| 1.5      | Learning and development . . . . .  | 8         |
| 1.6      | Ways forward . . . . .  | 8         |
| <b>2</b> | <b>What Is Good Financial Reporting?</b>                                  | <b>10</b> |
| 2.1      | Attributes: true and fair . . . . .                                       | 11        |
| 2.2      | Other qualitative attributes . . . . .                                    | 12        |
| 2.3      | Disclosures . . . . .   | 13        |
| 2.4      | Data with specific statistical properties . . . . .                       | 14        |
| 2.5      | Goals and objectives . . . . .  | 16        |
| 2.6      | Financial reporting as an emergent practice . . . . .                     | 20        |
| 2.7      | Summary . . . . .   | 21        |
| <b>3</b> | <b>Mechanisms for Choosing Financial Reporting</b>                        | <b>22</b> |
| 3.1      | Mechanisms and processes for collective choice<br>in accounting . . . . . | 23        |
| 3.2      | Social norms . . . . .  | 23        |

|          |   |           |
|----------|---|-----------|
| 3.3      | Popular vote or referendum . . . . .                  | 24        |
| 3.4      | Statutes and legislation . . . . .                    | 25        |
| 3.5      | Courts . . . . .                                      | 26        |
| 3.6      | Administrative and regulatory agency . . . . .        | 27        |
| 3.7      | Self-regulation . . . . .                             | 29        |
| 3.8      | Markets . . . . .                                     | 30        |
| 3.9      | Summary . . . . .                                     | 31        |
| <b>4</b> | <b>Standards and Rules</b>                            | <b>34</b> |
| 4.1      | Economics of standardization . . . . .                | 34        |
| 4.2      | Problems of identifying the social optimal . . . . .  | 36        |
| 4.3      | Monopoly or competition in standard-setting . . . . . | 37        |
| 4.4      | Standard-setting in the United States . . . . .       | 39        |
| <b>5</b> | <b>Social Norms</b>                                   | <b>45</b> |
| 5.1      | Nature of social norms . . . . .                      | 46        |
| 5.2      | Accounting norm: An example . . . . .                 | 47        |
| 5.3      | How do norms work? . . . . .                          | 50        |
| 5.4      | Courts and juries . . . . .                           | 52        |
| 5.5      | Insider trading . . . . .                             | 53        |
| 5.6      | Constitutions . . . . .                               | 53        |
| 5.7      | Norms in accounting . . . . .                         | 54        |
| 5.8      | Conflict of interest . . . . .                        | 55        |
| 5.9      | Final authority for decision . . . . .                | 57        |
| 5.10     | A dictionary and an inventory of accounting . . . . . | 58        |
| 5.11     | Norms or standards . . . . .                          | 61        |
| 5.12     | Beliefs about enforcement and effectiveness . . . . . | 63        |
| 5.13     | Norms versus standards in e-commerce . . . . .        | 66        |
| 5.14     | Limits of standards and rules . . . . .               | 68        |
| 5.15     | Engineering of social norms . . . . .                 | 75        |
| 5.16     | Possible reforms . . . . .                            | 76        |
| <b>6</b> | <b>Institutions</b>                                   | <b>77</b> |
| 6.1      | Evolution . . . . .                                   | 78        |
| 6.2      | US Corporate accounting . . . . .                     | 78        |
| 6.3      | Accounting rules . . . . .                            | 80        |

|   |            |
|---|------------|
| 6.4 Auditing . . . . .  | 85         |
| 6.5 Competition versus independence . . . . .                   | 88         |
| 6.6 Unintended consequences of pursuit of competition . . . . . | 89         |
| 6.7 Summary . . . . .   | 97         |
| <b>7 Ways Forward</b>   | <b>98</b>  |
| <b>Acknowledgements</b>   | <b>104</b> |
| <b>References</b>   | <b>105</b> |

## Abstract

Since the passage of the US federal securities laws more than eight decades ago, much regulatory effort has been devoted to improving financial reporting in business, government and not-for-profit organizations. Yet, evidence on improvements or abatement of misreporting by error or intent remains scarce. In the context of this experience, it may be useful to explore what we might mean by better financial reporting, and how we might define and implement processes to move in that direction. A broad agreement on the way ahead seems necessary to make progress.

Creating and sustaining institutions that follow a stable and conservative process for gradually adjusting the prevailing practices toward any long-term shifts may help evolve a better financial reporting environment. This approach departs from the tendency to issue new rules, often disregarding the lessons of practice, that has created much confusion and failures in financial reporting over the past century. The eagerness to deal with transaction innovations through new pronouncements ends up fueling the cycle of more innovations, misrepresentations and abuse. The enormous resources and attention devoted to written rules have been accompanied by waning professional responsibility for good judgment and regard for practice and practicality. This work argues for targeting a better balance between top-down written rules and emergent social norms as reflected in business and accounting practice through restraining activist institutions of accounting. Suggestions from exploration of whether and how better social norms can be engineered are only preliminary at this time.

*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 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 (Former Chair, US Securities and Exchange Commission) in Fingleton and Schoenmaker [1992]

# 1

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## Introduction

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What are, or should be, the properties of a good financial reporting regime? Financial reports serve many masters whose diverse expectations are in frequent conflict. Often, the powerful consider their own personal interest to be paramount. A good financial reporting regime is likely to be the result of creatively bargained trade-offs among its many functions, characteristics, and constituents.

### 1.1 Attributes, goals, and practice

There are three broad approaches to defining better financial reporting, based on attributes, goals, and practice. The first specifies some attributes of good reporting. Truth is a favorite prescription. Some other judgmental attributes often mentioned include (in alphabetical order) comparability, conservatism, consistency, cost, fairness, neutrality, predictive value, relevance, reliability, representational faithfulness, timeliness, understandability, verifiability, and uniformity. In the absence of quantification and trade-offs, they do provide only aspirational guidance for designing a financial reporting system and help to set the agenda for discussion and analysis. Instead of judgmental

attributes, financial reports can also be characterized by their statistical or descriptive contents. Examples of attributes that fall into this category are: correlation among security prices, volume, and other market, accounting, industry, or macro-economic variables, time series properties of reported variables, the power to predict prices, financial stress, and other future events of interest.

A second approach is to focus on goals of society or of some specified individuals or groups. Generating greater wealth and prosperity for society by enabling organizations to operate more efficiently is an example of a social goal. Distributive justice is equally important to many people. Reducing the cost of capital for reporting entities is another frequently mentioned social goal of financial reporting.<sup>1</sup>

Narrowing the focus to the goals of participating individuals and groups simplifies the problem. But it also sets aside the legitimate interests of other participants. For example, one could define as good that financial reporting which helps equity holders of a business make more efficient investment decisions. Indeed, a large body of literature in accounting sets out to do just that, possibly because the data on the performance of equity investment is ubiquitously available. The popularity of this approach need not distract one from considering legitimate interests of other individuals and groups such as creditors, employees, communities, and governments in financial reports of organizations.

Looking to practice for guidance on defining and understanding the financial reporting regime is the third major approach. Large parts of accounting, law, medicine, and other professions arise from practice and experience. They are based on what Hayek [1991] called “the extended order”: “. . . a framework of institutions — economic, legal, and moral — into which we fit ourselves by obeying certain rules of conduct that we never made, and which we have never understood in the sense of which we understand how the things that we manufacture function.” Even for

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<sup>1</sup>However, it is unclear why reducing the cost of capital to the investing entities should be socially desirable, when it also means reducing the rate of return to the investors (which is just the flip side of cost of capital). Reducing the price of potatoes simply transfers wealth/income from farmer to consumers without necessarily increasing or decreasing social welfare. What is so special about the price of capital to make this argument inapplicable to that context?



manufactured things — a car for example — it is not clear how many people really understand how all of their parts function.

The role of social norms that emerge through a myriad interactions among individuals, organizations, and of the socio-economic environment in shaping the financial reporting regime has received only limited attention in recent accounting literature. From a mechanistic perspective, a financial reporting regime may be thought to have been constructed from its elements — perhaps written rules — like a wall is constructed from bricks and mortar. While this perspective dominates accounting discourse, it has proved to be difficult to construct a practical model of accounting from its identifiable elements — the “bricks.” Instead, practice has important emergent properties seen in the extended order, but not in the components. From this perspective, long encapsulated in the traditional meaning of the familiar phrase “generally accepted accounting principles” (GAAP), a financial reporting regime arises from its general acceptance in the community of business managers, accountants, investors, employees, etc.

These three approaches — attributes, goals, and practice — are not mutually exclusive. It is unlikely that any one of them is entirely satisfactory by itself; they complement one another. This book argues that such a syncretic attitude will help to build a better financial reporting regime.

## **1.2 Perspectives by time scale**

Perspectives varied in detail and time often yield different insights into the nature and origins of a phenomenon. For example, walking through a neighborhood, flying over a city, and looking at earth from outer space allow one to see the same surface of the earth in very different ways, and yield related but quite different observations of the dwellings, landscape, and activities observed (see Figure 1.1). We can look at financial reporting also from various perspectives of time and detail. An auditor learns about different aspects of the same firm in checking a sheaf of customer invoices, in conducting an analytical review of the financial statements, or in assessing the performance of an organization over the



**Figure 1.1:** Three Perspectives on the surface of the earth. (a) Ground level. (b) Aerial perspective. (c) The blue marble (National Aeronautics and Space Administration (1972). AS17-148-22727: Picture taken by Apollo 17 crew on Dec. 7, 1972).

years. The facts rarely speak for themselves; what we observe depends on the level of spatial or temporal detail in our chosen perspective, and what we are looking for in a given perspective.<sup>2</sup>

Most accounting discourses on a financial reporting regime are focused on the treatment of specific types of transactions and possible ways of altering the treatments through rule-making or other regulatory actions. It takes a longer run view of the consequences of repeated cycles of transaction innovation followed by regulatory action, and includes institutional innovation as well as evolution of social norms as elements of the process that shape the financial reporting regime.

### 1.3 Rules and institutions

It is useful to think of three levels of analysis in accounting: transactions, rules for classifying and reporting transactions, and socio-political-economic institutions for making, implementing, and enforcing the rules. Since all events are not treated as transactions in accounting, the first level of analysis identifies which events are to be treated as transactions. The second level develops a classification scheme for transactions based on their observable attributes, and chooses how each class of transaction is to be recorded and reported. At the third level

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<sup>2</sup>[www.invisiblegorilla.com](http://www.invisiblegorilla.com) has interesting video examples of the phenomenon that people do not notice “obvious” things when they are not looking for them (accessed July 31, 2015).

lies the development of institutions to perform and oversee the tasks at the first two levels. Besides the legislatures and courts, bureaucratic regulatory and coordination structures in the government and private sector are examples of such institutions in the United States.

Most accounting instruction concerns the first two levels: learning to identify events that are considered transactions, and to decide how the transactions are to be classified and reported under the prevailing regime. How and why the rule-making institutions choose a particular rule receives less attention in our teaching. Even rarer is the analysis of the alternative design or evolution of institutions. These oft-ignored topics are important because the structure of institutions helps determine the scope and nature of the events they recognize as transactions, and the rules they promulgate.

To understand accounting regimes, a broad perspective on accounting institutions that create the regimes is needed. In the United States, for example, the relevant accounting institutions include not only the obvious candidates such as the federal Securities and Exchange Commission, the Financial (as well as the Government) Accounting Standards Board, the Government Accountability Office, and the Public Company Accounting Oversight Board, but also the American Institute of Certified Public Accountants, state securities regulators and CPA societies, various state and federal courts and industry regulatory commissions and revenue departments, all operating under their respective statutes, charters, regulations, and procedures. Although we shall confine our attention here to the first few larger institutions named above, the role of local institutions such as the chapters of Financial Executives International and the associations of accountants is also important.

## **1.4 Social norms**

While rules and institutions are more formal, a great deal of our lives, including professional practice, is governed by less well-defined social norms. These are shared expectations held of one another's behavior in the relevant community. In a broader sense, social norms also compose

an institution. Although they have played an important role in all professions and various aspects of our lives, their role in financial reporting has been muted during the recent decades. We shall explore the possible reasons and consequences of this phenomenon and discuss some options for the future.

### **1.5 Learning and development**

Social systems learn, develop, and change over time. To the extent we can design the institutions of accounting, they need to have a built-in capacity to learn and adapt to changes in the environment without being destabilized. Standardization of practice and their adaptation have an inherent conflict. Widely adopted and enforced standards are also more difficult to adapt to environmental changes. For example, the United States was the first to invest large amounts of capital in the mechanization of weights and measures and that standardization made it more costly and difficult to adopt the metric system which is now used almost everywhere else in the world.

In the past two decades, there has been a strong push towards standardization of financial reporting across the globe, accompanied by claims of its benefits. We analyze the consequences of standardization in financial reporting.

### **1.6 Ways forward**

Finally, we explore the future of financial reporting, especially in light of the active interaction among financial reporting, law and financial engineering. The environment of financial reporting is defined in a significant measure by law and financial engineering. To the extent that rules of financial reporting are written down, they facilitate attempts of managers and their advisors to design newer transactions, instruments, and even organizational forms to bypass or defeat the intent of the rules.

Many conflicts and disagreements about accounting and auditing end up in the courts of law for their final resolution. An expanded role for the common law approach where community norms are decisive may help improve financial reporting.

# 2

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## What Is Good Financial Reporting?

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There is little agreement on an answer to this question. Consider seven perspectives to identify “better” financial reporting; three based on attributes of financial reports, three on the goals they seek, and one being the current practice [Sunder, 2016]. The attribute-based approaches include (1) pursuit of truth, (2) assessment based on judgmental or qualitative attributes of the reports considered desirable, harmful, or deserving a balance, and (3) some measurable statistical or descriptive properties of the data, disclosures, and explanations contained in the reports. Three objectives-based approaches include (1) seeking to fulfill some objectives of financial reporting itself (2) the efficacy of financial reporting in serving some broad societal goals, and (3) fulfilling the goals of one or more specific classes of participants. A final approach sees accounting simply as a social practice, arising from complex human interactions, but not necessarily derivable from known attributes or goals.

Given the nature of collective choice and social policy, it is rare for such attempts to clearly identify what constitutes better financial reporting. Trade-offs must be made in the presence of noncommensurate and conflicting attributes, as well as within- and across-person

objectives. The absence of reasonable data on preferences, costs, and benefits lead to ambiguous conclusions. Indeed, caution is necessary because it is challenging to be both knowledgeable and confident about such formulations.

## 2.1 Attributes: true and fair

The pursuit of truth is often mentioned as a desired property of financial reporting. Despite its apparent simplicity, difficulties arise in practical application of the criterion. For example, MacNeal [1939] considers market values to be the only truth. In his review of MacNeal's book, Paton [1940] pointed out the arbitrary nature of what is chosen as the truth. In accounting, as elsewhere in life, the appeal of pursuing the simple truth is difficult to resist. The problem is that what is simple is not always true; what is true may not be simple. Moreover, from a statistical perspective, truth is not a 0–1 property, but a matter of degree, which might be measured, for example, by root mean squared deviation or other similar metrics of precision or its inverse.<sup>1</sup>

When quantified in this manner, it is difficult to defend truth as the best determinant of the quality of financial reporting; trade-offs with other attributes come to mind immediately. The use of “true and fair” as a criterion in financial reporting is an attempt to combine the starkness of “true” with the global judgment and the sense of balance that “fair” brings to financial reporting. The Joint Stock Companies Registration and Regulation Act of 1844 of the UK included this concept in the statute [McGregor, 1992; Sunder, 2010b] as did the UK Companies Act of 2006.<sup>2</sup> True-and-fair is also an easy-to-comprehend benchmark for financial reporting that does not depend on the technical jargon of

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<sup>1</sup>Within the framework of true–false two-valued logic, the truth value of a forecast (e.g., 40% chance of rain tomorrow) cannot be determined even ex post. Many disputes about history arise from lack of verified shared information.

<sup>2</sup>Chapter 4 Section 393(1) reads: “The directors of a company must not approve accounts for the purposes of this chapter unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss” for individual as well as group accounts. Further, subsection (2) requires “The auditor of a company in carrying out his functions under this Act in relation to the company's annual accounts must have regard to the directors' duty under subsection (1).”

accounting; the president of the United States used it in his promise to the public on July 9, 2002 in the aftermath of Enron, WorldCom, etc.: “We are moving corporate accounting out of the shadows so the investing public will have a true-and-fair and timely picture of assets and liabilities and income of publicly traded companies.”

Not surprisingly, companies in the United Kingdom, where true-and-fair override is permitted, tend to use it opportunistically to spruce up their weak performance and provide less informative financial reports as measured by the explanatory power of reported book value and earnings per share for share prices [Livne and McNichols, 2009, p. 20]. The use of the true-and-fair override itself is a valuable piece of information for the users of financial reports, and the firms that use this costly signal tend to be in a more precarious financial position.

## **2.2 Other qualitative attributes**

Over years of accounting discourse, comparability, conservatism, consistency, cost–benefit efficiency, faithful representation, neutrality, relevance, reliability, robustness to manipulation and fraud, timeliness, uniformity, and verifiability (listed alphabetically here) are among the attributes proposed for a preferred system of financial reporting. In the context of governmental organizations, citizen empowerment and engagement with the organization, public accountability, and transparency are often added as desirable attributes of their financial reporting.

Most of these interrelated attributes have been widely discussed and largely accepted as desirable in financial reports with four important caveats. When choosing between two or more alternative practices, such a list of desirable attributes inevitably forces the rule writers to make difficult trade-offs between various pairs of attributes, say, faithful representation and timeliness, and between relevance and reliability. The list of attributes itself provides little guidance on making such trade-offs to improve financial reporting. Second, it is difficult to resolve conflicts among the interests of preparers, auditors, and users; what is desirable to one group is not necessarily preferred by others. Third, meanings



of terms such as uniformity, comparability, and conservatism, obvious at a cursory glance, become less clear on closer scrutiny. Uniformity of classification has no obvious interpretation in a multi-attribute world, because “similar treatment of two transactions which have any similarity” and “dissimilar treatment of two transactions which have any dissimilarity” criteria yield radically different destinations in pursuit of uniformity [Sunder, 1984, 1997, Chapter 9]. Comparability in a world where no two transactions or events are exactly alike is similarly undefinable. For example, Weinberg (1992, Chapter 2, “On a piece of a chalk”) argues that it is not possible to completely define even a simple object such as a piece of chalk. If one is willing to go into enough details, no two pieces are alike. The same is true of accounting events and transactions.

Joyce et al. [1982] found from their experiment with the former members of the Accounting Principles Board and the Financial Accounting Standards Board that they agreed sufficiently on the meaning and importance of only two (cost and verifiability) of the eleven qualitative attributes they examined; the others proved too difficult to be associated with a shared meaning, even for these experts who, as members of the Boards, had spent years sharing their thoughts on such matters.

## 2.3 Disclosures

Users of financial reports often ask for additional disclosures in financial reports, and sometimes regard more detailed and timely disclosures as better financial reporting. Many features of current financial reporting, such as consolidation of controlled entities, reporting by business and geographical segments, separation of core and noncore businesses, quarterly reports, and disclosures of financial instruments, off-balance sheet financing, and uncertainties were demanded by users in the past. In 1994 AICPA’s Jenkins Committee recommended that reports include not only financial but also nonfinancial information. After the practice and the legal regime had long discouraged inclusion of forward looking information for the fear of fraud and lies, the Jenkins Committee as

well as the US Congress encouraged inclusion of such information in corporate financial reports under a safe harbor rule (i.e., no penalties if such information subsequently turns out to be wrong) through Private Securities Litigation Reform Act of 1995.

Demands for additional disclosures land on the doorsteps of regulators, and are resisted by preparers on the grounds of presumed litigation risk, direct costs of disclosure, or indirect costs of giving away proprietary information to competitors. Preparers prefer to decide for themselves which information to disclose and when to do so [Dye, 1985]. Besides its other roles, disclosure can also serve as an instrument of information signaling by preparers, and regulated disclosure deprives the better-run organizations of this useful instrument for distinguishing themselves from organizations with weaker performance [Levine, 1996].<sup>3</sup>

When regulators yield to requests for mandating additional disclosures in financial reports, the reports may become more detailed, but not necessarily more informative. Important pieces of information can get lost in voluminous details included in the report to fulfil regulatory requirements. Bloomfield [2012] argues that the firms be encouraged or required to draw readers' attention to important items by "elevating" them above the less important details. Heterogeneity of interests of the user community with respect to the relative importance of disclosures makes regulatory implementation of this proposal a difficult challenge.

## 2.4 Data with specific statistical properties

Beyond the qualitative characteristics and disclosures discussed earlier, the meaning of better financial reporting can also be specified in terms of statistical attributes of the reported data. Perhaps the best known of such attributes is the co-variation between data from accounting reports and stock markets. Larger correlation is treated as a measure of better financial reporting under the catchy but often misleading label of "value relevant" reporting. The term value relevance suggests causation

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<sup>3</sup>Similar problems arise in attempts to narrow accounting measurement rules through regulation. Attempts to suppress various forms of earnings management is an example [see Arya et al., 1998, 2003].

from financial reports to market prices, but causal inference from correlations is difficult to make. Security markets process information from multiple sources to arrive at prices; any correlations between accounting and market data cannot be assumed to be rooted in financial reports alone. This value relevance perspective on better financial reporting assumes that security markets are efficient (in the sense of the prices being in the neighborhood of the fundamental values), in spite of the difficulty of identifying fundamental values [Hirota and Sunder, 2007; Hirota et al., 2015] and the large empirical and theoretical evidence to the contrary [Shiller, 2000]. Finally, this perspective reverses the dependence of price and other market data on information (including financial reports), to make market data the ultimate arbiter of what information financial reports should furnish to the market. In other words, under the value-relevance perspective, instead of being “for the markets”, financial reporting is derived “from the markets” [Sunder, 2011a,b].

Moriarty and Livingston [2001] examine two metrics of quality of financial reporting: the number of announced financial reporting restatements and market value losses from restatements as a percent of total market value of equity securities. The number of restatements is a joint consequence of the number of erroneous financial reports and the quality of enforcement. A time series comparison of restatements and the market values losses that accompany them does not allow us to disentangle the frequency of misstatements from the probability of being caught by the regulators.

To the extent financial reports may help make better decisions such as valuation, lending, and various kinds of predictions including financial distress and bankruptcy, regulation of banks and utilities, and attracting investment and human capital to more productive enterprises, it is possible to define better financial reporting on the basis of the quality of decisions financial reporting may be able to support. Since decision models that use financial data can always be adjusted, which financial reporting regimes yield a better basis for making various kinds of decisions is largely an empirical matter. The empirical results depend not only on the financial reporting regimes but also on how well the decision models have been adapted to each of the regimes being

compared. Since most jurisdictions allow only one financial reporting regime to operate for a given class of firms, such empirical comparisons of decision-usefulness must necessarily depend either on cross-sectional comparisons across jurisdictions or time-series comparisons within a jurisdiction when a regime is changed. The difficulty of controlling for everything else being not equal in such studies renders empirical determinations of better financial reporting a major challenge.

## 2.5 Goals and objectives

In the preceding section we discussed attempts to define better financial reporting in terms of desired attributes including truth, other qualitative characteristics, disclosure, and statistical properties. Another way of approaching better financial reporting is by considering the goals or objectives of financial reporting itself, of society, and of some specific members or groups in society. Since financial reports are artifacts created to serve human objectives, it seems best to include the objectives of financial reports into human objectives at either societal or group or individual levels as proposed by [Dopuch and Sunder \[1980\]](#).<sup>4</sup>

### 2.5.1 Societal goals

That financial reporting should serve broadly defined societal goals such as the creation of wealth and livelihood, the promotion of social cohesion and justice, and the creation of markets for physical, financial, and human capital that promote economic efficiency is widely supported. Less familiar is the role of financial reporting off the equilibrium paths, in raising red flags when things go wrong, in the hope of returning the system back on its track. However, like other broad propositions, agreement on which financial reporting regimes are better at attaining such goals is difficult.

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<sup>4</sup>They also analyze three important but largely overlapping official pronouncements (Accounting Principles Board Statement 4 or APBS4, Trueblood Report or AICPA 1973, and Statement of Financial Accounting Concepts 1 or FASB 1978) to define these objectives issued contemporaneously with the rise of decision usefulness criterion.

The higher material wellbeing of society today is a result of organizing individual talent and effort in small or large groups and communities, and linking them so they can interact in transient but substantially predictable ways. The existence and functioning of these organizations in public and private sectors is made possible by financial reporting. Organizations gather physical, human, and financial capital and organize it to produce social surplus, which is their economic contribution to society [Sunder, 2008].

Accounting and financial reports are necessary for organizations to attract various forms of capital, and to ensure that the participants have a reasonable chance of receiving their share of returns on their respective contributions [Sunder, 1997]. In this sense, financial reporting is necessary for organizations, including society which is a larger organization, to sustain itself.

“Information for Better Markets” was the theme of a recent conference organized by the Institute of Chartered Accountants of England & Wales. It would be a stretch to imply that markets should be treated as stand-ins for the economy or society as a whole (and the organizers didn’t do so). The idea of “better markets” needs some further explication because the term could be used to refer to market volume, information efficiency, allocative efficiency, liquidity, low transactions cost, broad accessibility, transparency, etc. Also, market organizations are not necessarily neutral, and they can favor some participants at the expense of others. They can be organized to favor dealers, brokers, institutions, small investors, or investors in companies who run the stock exchanges. Considering all these possibilities, it is unclear how one might choose an accounting regime to create better markets. Further, creation of markets and reduction in the cost of operating them promotes financialization of society, which is not necessarily desirable from a broad sociological perspective.

In a world where individuals seek their own respective goals, financial reports help to organize them into coordinated networks, inform them about the functioning of the network, and discipline individuals so that personal pursuits do not overwhelm its collective functions. Financial reporting systems discipline not only individual actions but also alternative and competing sources of information they may have access

to. In this sense, good financial reporting should help build stability and an element of predictability to the functioning of organizations.

Stabilizing a social system involves sacrificing some sensitivity and speed of adjustment, and anticipating human reaction to variations.<sup>5</sup> Appropriate methods of accounting under risk and uncertainty, for example, depend on whether the possibility-of-harm or the dispersion-of-outcomes meaning of risk is applicable to human behavior. The harm concept of risk leads accounting to the long-established lower-of-cost-or-market or conservative methods, while the dispersion concept leads to mark-to-market valuation [Sunder, 2015]. Friedman et al. [2014] suggest that the evidence favors human aversion to the possibility of harm; aversion to dispersion of outcomes has little supporting evidence.

It has often been claimed that an important function of financial reporting in business organizations is to help reduce the cost of capital. There are two objections to this claim. First, cost to a business organization is profit to the investor supplying the capital. To claim that financial reporting should be chosen to reduce the cost of capital is also to claim that it should be chosen to reduce the returns to investors. Second, cost of capital is just another price (i.e., a rate of exchange) of a factor of production, and it has not been shown that lowering the price of capital (or of cars, food, or anything else) improves social welfare unless the interests of people on the other side of the transaction are deemed irrelevant.

### **2.5.2 Goals of individuals**

Addressing the interests and therefore impact on the decisions of various classes of participants in an organization is a third approach to giving meaning to better financial reporting. Enabling them to make better-informed private decisions of their own is mentioned often. In this decision-making perspective, participants have preferences and objectives, which they combine with information from financial reports and alternative sources to formulate and solve their decision problems. More broadly, this meaning of better financial reporting can be said to

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<sup>5</sup>The same is also true of engineering systems.

help the participants of an organization improve their individual and collective welfare.

However, four sources of ambiguity arise in this meaning. First, the goals and information demands of various groups of participants do not necessarily coincide across, and even within, the groups. It is difficult to choose a financial reporting system to serve a diverse group that may include diametrically opposed interests. A second problem is that information needed by individuals may depend on their personal circumstances, which change dynamically, and are unknown and unknowable to those who select the financial reporting system. Third, individual decision usefulness criterion for better financial reporting assumes little or no interaction among their individual decisions. But interactions among rational decisions of “better informed” individuals may yield less desirable outcomes for some or all of them, as compared to outcomes from not-so-informed decisions [see [Baiman, 1975](#)]. Fourth, as [Demski \[1973\]](#) points out, from Blackwell’s [[Blackwell and Girshick, 1979](#)] theorem, we know that a better information system for individual decision must be strictly finer, and this fineness condition is unlikely to be met by any particular standard. [Goetz \[1939\]](#) and [Schmalenbach \[1948\]](#) proposed making basic transactions records available to all users so they can freely aggregate the data in customized ways that might suit their individual needs. This proposal is better known as [Sorter’s \[1969\]](#) “events” approach to accounting.

Difficulty with defining better financial reporting in terms of decision-making information has often been sought to be ameliorated by narrowing the presumed target of financial reporting to a single group — investors, sometimes narrowed further to shareholders. Although the vast literature that adopts this “shareholder perspective” on the merits of financial reporting rarely articulates its rationale, we can venture some guesses. First, a plausible reason lies in the large following of Milton Friedman’s [[1970](#)] widely misunderstood dictum “profit is the only goal of business,” transmogrified into “maximizing shareholder values (as measured by the market price of shares) is the only goal of business.” From there comes the long, incredible, but seemingly innocuous leap: “maximizing share prices is the goal of financial reporting regulators/standard-setters.” This leap has two

important dimensions. Shareholders are not the only group in society whose interest regulators and standards are charged with protecting. Second, informing shareholders so they can make better investment decisions is not the same thing as financial reporting that will increase stock prices and returns.<sup>6</sup> In accounting theory or empirical literature, higher co-variation between financial reporting and stock market data has been linked neither to serving the interests of shareholders nor to efficiency of their investment decisions. Finally, Friedman's dictum was proposed within the context of following the rules of society, and its financial reporting regime helps define the rules.

## 2.6 Financial reporting as an emergent practice

Beyond possessing some desired attributes or pursuing some goals, one can look at financial reporting simply as a social phenomenon that just “happens,” like the ways in which we eat, speak, wear clothes, relate to one another, work, and entertain ourselves. Since the complexity of social phenomena makes it difficult to derive our way of living as rational constructions from some well-defined preferences, attributes, and goals, we tend to rationalize it anyway. In fact, more often than not, we infer preferences and goals from the way we live (e.g., he must like the color blue because he wears blue shirts).

In accounting, this Panglossian perspective (coined after the optimistic tutor Pangloss in [Voltaire's](#) [1759] *Candide*), has a large following. Accounting is the way it is, the argument goes, because it must be the best; otherwise it would not have been this way. The popularity of this so-called “positive theory” has almost precluded serious discussions of policy problems of accounting from important parts of accounting literature during recent decades.

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<sup>6</sup>In the wake of the financial reporting scandal at Enron in 2001, the stock price dropped from the 90 dollar range to less than a dollar. According to one estimate, each share of Enron should have been worth about \$5 at the time. Whether the shareholders lost \$85 ( $= 90 - 5$ ) or \$4 ( $= 5 - 1$ ) is a matter of some debate. Are shareholders interested in financial reports which help determine the market price of their stakes accurately, or to maximize the market price? The answer should not be controversial, but it remains so.



As a practice, financial reporting can also be seen as a ritual of modern life. Rituals are a repeated sequences of actions performed in religious, social, organizational, and individual contexts, either without a stated purpose, or without an empirically identifiable link to their purported purpose. They are explanations of themselves — we do them because we do them. University commencements, tribal rain dances, visits to places of worship, wedding and funeral ceremonies, greetings and goodbyes are examples of rituals that pervade life in all societies. According to Bell [1997, pp. 138–169], rituals may be prescribed by the traditions of a community and characterized by formalism, traditionalism, invariance, rule-governance, sacral symbolism, and performance. To a skeptical eye, financial reporting also appears as a ritual full of symbolism and little substance.

Some purposive activities continue through the force of habit, tradition, or superstition long after their original purpose is lost to changing circumstances or social memory. A better “rain dance” is not assessed by whether precipitation follows; other measures such as the number of participants, colors of the costumes, or sumptuousness of the feast that follows may replace the objective criteria. Until better evidence on the instrumental effectiveness of financial reporting in attaining its attribute- or goal-based rationalizations becomes available, financial reporting as a ritual cannot be rejected out of hand.

## **2.7 Summary**

In summary, “better” in financial reporting could be defined to mean multiple things: meeting specified societal or individual goals, or possessing some general qualitative or specific statistical attributes. It is difficult, even at a conceptual level, to obtain agreement on what kind of financial reports do or can meet the criteria within either of these interpretations. We do not yet know if it is a ritual we engage in simply because we have done so for a long time. After exploring the range of possibilities, we return to this question in the final section.

# 3

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## Mechanisms for Choosing Financial Reporting

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How do we think about, design and choose better financial reporting regimes? The topic has received much attention during the past century. An initial step is to recognize that this problem is not unique to accounting. Humanity has strived to find better ways of organizing various aspects of society over the millennia, and written rules are not the only instrument for attaining that end. Since writing rules has been an important part of defining a financial reporting regime over the past century, it is worth noting that there are more than 500 domestic standard-setting organizations in the United States alone, and many more in other countries, engaged in the task of defining the technical and business environment and setting standards for everything from ships to sockets. In addition, there are international bodies that do the same for diverse fields such as communications across national boundaries. Reflecting on the problem of setting an accounting regime in the larger context of parallel social processes for other products and services may help us appreciate the costs, benefits, limitations, and economics of developing a better financial reporting regime [[Jamal and Sunder, 2014](#)].

Divergent pulls in social policy are hardly unique to financial reporting; it is common to most aspects of law, regulation, and collective choice in general. Financial reporting includes elements of collective as well as private choice. Looking at aspects of economic life outside of accounting may help gain some perspective. Analytical derivation of solutions to problems of collective choice is difficult for reasons similar to those outlined for the problem of selecting criteria for better reporting in Section 2. Process can be an alternative to criteria for choice. Perhaps it is possible to develop a socially acceptable process for defining and developing financial reporting in the hope that its outcome will be an improvement, at least by some broad subjective judgments if not by criteria-based analysis.

### **3.1 Mechanisms and processes for collective choice in accounting**

Given the difficulties of choosing and applying a priori social welfare criteria, human societies have developed and employed a variety of social choice mechanisms to address the problem. While rules written by a regulatory body are frequently employed in financial reporting, they are neither the only nor necessarily the best mechanism for all aspects of financial reporting. At the outset, it is useful to consider the characteristics of the available alternatives. They can be classified into eight broad categories — social norms, popular vote or referendum, legislation or statutes, courts, bureaucratic regulation, self-regulation, and market — recognizing that in practice they may coexist and overlap [[Sunder, 1988](#)].

### **3.2 Social norms**

Social norms, such as natural languages, emerge from grass roots. It is a diffused collective choice mechanism with minimal role for a centralized authority. The process of such emergence is not well-understood, and it does not produce results on the demands of a set time table. It can deal with matters of broad principle, as well as fine-grained distinctions.

Pacioli's fifteenth century text *Suma de Arithmetica, Geometria, Proportioni et Proportionalita* codified the prevailing accounting practices of Italian merchants of his time. His book is an attempt to capture the social norm of accounting of his time. Indeed, the phrase "generally accepted accounting principles" reflects the grass roots social norm origins of accounting and financial reporting.

Financial reporting was largely left to be defined by social norms until the number and size of publicly owned business enterprises grew to a significant proportion of economic activity. Rapid growth of larger complex publicly traded organizations in manufacturing, transportation, utility, and service industries placed additional demands on financial reporting systems that could no longer be met by the social norms approach alone; in the second half of the twentieth century, the GAAP label was gradually appropriated by corporate bodies with legal authority to make and impose top-down rules on reporting entities. Social norms have taken a back seat ever since.

### 3.3 Popular vote or referendum

In making collective choice by popular vote or referendum, individual citizens have the opportunity to indicate their preferences directly. Referenda can work reasonably well as social decision mechanisms when the citizens have to choose from a few simple, ready-to-understand alternatives such as "X or Y" or "Yes or No".<sup>1</sup> Permitting legalized gambling, the sale of alcoholic beverages, and caps on real estate taxes are examples of issues amenable to this form of collective decision-making.<sup>2</sup> As the number and complexity of alternatives increases, the efficacy of a popular vote drops because most citizens cannot have all of

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<sup>1</sup>However, Arrow's [1951] "impossibility theorem" shows that when voters have three or more distinct alternatives (options), no ranked order voting system can convert the ranked preferences of individuals into a community-wide (complete and transitive) ranking.

<sup>2</sup>Even a simple yes-no referendum can yield unpredictable results which do not necessarily reflect the popular will. The June 2016 "Brexit" referendum on whether the United Kingdom should remain a member of the European Union is a recent example.

the knowledge to make an informed choice. The formulation of alternatives presented becomes an important part of the decision that cannot be handled by referenda. Moreover, when the voters do not comprehend the implications of the collective choice at stake, they become more susceptible to suggestions, advertising, and demagoguery. It is not surprising that financial reporting choices have not been subjected to referenda.

### **3.4 Statutes and legislation**

Statutes are top-down decisions of the ruling authority. In democratic systems formulation, debate, and approval of statutes is entrusted to a legislature consisting of representatives elected by constituents to speak on their behalf. Whether the legislature passes a statute depends on the level of support for such action from a sufficient number, usually a majority, of its members. It can take no action unless one of the proposals on the table gains enough support. But “no legislation” is also a choice for leaving the status quo undisturbed.

Legislators are free to argue for proposals that favor them or their constituents, and they often do so. In legislative decision making the conflicting interests are articulated, debated, and bargained on, with little of their reasoning and motivations left hidden (except when bargaining occurs in the proverbial “smoke filled” rooms off the legislative floor). All sides have the opportunity to air their views. Given their broad responsibilities across the range of issues in the political domain, few legislators can be expected to have the time, ability, or inclination to become knowledgeable about technically complex issues in financial reporting. Even when legislators engage with such issues, they may not understand them, and leave the details to be worked on by their staff.

In the 1990s, the US Congress got involved in accounting for executive stock options under lobbying pressures from the technology industry, and it took many years and major corporate failures and scandals that surrounded the bust of the dotcom bubble, the Sarbanes–Oxley Act of 2002, and recognition of the dangers of corporate kowtowing by Congress for US financial reporting to recover from that misguided

legislative intervention. The French government’s intervention with the International Accounting Standards Board in the wake of accounting problems at Société Générale had similar effects. The title of Romano’s [2005] paper “Sarbanes–Oxley Act and the Making of Quack Corporate Governance” expresses the serious doubts about the wisdom of direct legislative intervention in financial reporting.<sup>3</sup>

As Coase [1960] pointed out, reassignment of property rights (which we interpret to include information rights) through legislation may transfer wealth but its effect on resource use depends on the cost of engaging in transactions in those resources. When there are no transaction costs, resource usage is independent of the assignment of property rights. Legislation and regulation of financial reporting generally reassign property rights in information. Since transactions in an intangible resource such as information are hardly friction less, it is safe to assume that such actions also have an effect on how much information is produced, and who uses it.

### 3.5 Courts

Unlike the legislatures where the members are free to argue for their own or constituent interests, judges in courts must maintain neutrality. While judges also are under pressure of the arguments advanced by the plaintiffs and defendants, they are expected to decide on the basis of common or statutory law, and not on their personal preferences. Violations of this judicial norm risk loss of status for the judge. In contrast with the legislators who may consider multiple alternatives, courts typically have only two sides before them, and must decide one way or the other.

Spacek [1958] headed the major accounting firm of Arthur Andersen & Co. when he proposed that financial reporting disputes be resolved in a specialized accounting court endowed with expertise to handle the finer points and technical details that might be lost in a general court. Such a court might be able to use common law to make judgments about whether the financial reports under scrutiny present a “true and

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<sup>3</sup>Also see Chambers et al. [2010].

fair” picture of the status and the performance of the relevant entity in a manner analogous to determination of “guilty beyond a reasonable doubt” in criminal cases. Creation of such courts may help reduce the rapidly expanding administrative and regulatory burdens of making and enforcing rules. Spacek’s proposal has not received much traction in the accounting, business or regulatory communities. Instead, the administrative and regulatory approaches to address the problems of financial reporting have become further entrenched.

### **3.6 Administrative and regulatory agency**

In the 1930s, the US Congress handed the responsibility for regulation of publicly traded companies’ financial reporting to the newly created Securities and Exchange Commission (SEC). Commissioners of the SEC, as well as other regulatory agencies in the US system, function largely independently of the executive branch of government, and are answerable to the US Congress. This administrative arrangement has the advantages of flexibility, innovation and experimentation with regulatory methods (e.g., accounting for inflation and for oil and gas exploration); however, it also risks major failures to maintain the quality of financial reports (e.g., Enron, WorldCom, Global Crossing, etc.).

The administrative approach to regulation appears to work well when the agencies exercise their discretionary powers and judgment for the public interest. For example, the SEC has not defined insider trading much beyond “trading on material non-public information” although it has been under constant pressure to clarify the meaning of this phrase. Regulators in Japan and some other countries have tried to write out the specific details of what the phrase means, but have in effect provided wrongdoers with road maps for evasion.

Such care is often missing in writing rules of financial reporting. Take recognition of revenue as an example. In 1932, the American Institute of CPAs Special Committee on Cooperation with Stock Exchanges, chaired by George [May](#) who was strongly opposed to officially prescribing accounting methods,<sup>4</sup> drafted a few “broad principles” after

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<sup>4</sup>In a letter to M.C. Rorty he wrote: “My idea would be that every corporation should adopt a method of accounting described in considerable detail. This method

consultation with corporate officials, lawyers and accountants in five short paragraphs.<sup>5</sup> According to Zeff (1972, p. 124 citing AICPA 1932–34), after receiving the “general acceptance” from corporations and accounting firms, New York Stock Exchange’s Governing Committee required “that they should be followed by all listed companies — certainly, that any departure therefrom should be brought expressly to the attention of the shareholders and the exchange.”

During the eight decades since, rules for revenue recognition have been rewritten many times, adding details for specific types of transactions in specific industries such as software and real estate as clarifications and “guidance,” or backing off from specifics to move toward general principles, and then issuing specific guidance again. Even before the Financial Accounting Standards Board and International Accounting Standards Board’s (FASB/IASB’s) joint prescription *Revenue from Contracts with Customers* comes into effect in 2017 (reporting periods beginning after December 15, 2016), thrice in 2015 the Boards proposed to issue new clarifications on collectability, non-cash consideration, completed contracts at transition, and new practical expedients and technical corrections. PricewaterhouseCoopers’ [2014] published guidance for its clients on implementing this new rule has 264 pages.

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should be certified by its auditors as being in accordance with reasonable standards of business practice, and should be freely disclosed. The officers should then be guilty of falsification of accounts if they knowingly put forward any accounts not in conformity with the methods of accounting so adopted. . . . The trouble with an ‘official’ system of accounting is, that while it is possible to lay down broad principles, wide variations are possible within the limits of such principles, and which variations should be adopted is a question on which one cannot rightly be dogmatic.” (cited in Grady, 1962, p. 62 and Zeff, 1972, p. 123).

<sup>5</sup>The first of the five paragraphs of AICPA (1932–34, Exhibit I, pp. 4–14, italics added) cited in Zeff [1972] reads: “Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily be charged against income account. *Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured.* An exception to the general rule may be made in respect of inventories in industries (such as the packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.”



As May presciently pointed out (see footnote 4 in Section 3) this addresses the basic dilemma of regulators. If they write down only general principles, they allow themselves room to exercise their judgment in bringing enforcement actions when they see a violation of the principles. The defense usually consists of pointing out the lack of specificity in the principles, and calls for clarification (or “guidance”, a frequently used term in the context of financial reporting). Every clarification adds details to the principles — a step in transforming them into rules, and opens up new loopholes and substitutions.<sup>6</sup> Detail and complexity gradually inch up on demand from the regulatees, making it progressively more difficult for the agency to exercise judgment based on general principles of reporting. The failure to follow this process attracts charges of arbitrariness and absence of due process, which are difficult to rebut in a democratic polity.

A second source of difficulty lies in the endogeneity of business transactions and events, and the rules for including them in financial reports [Sunder, 2011b; Dye et al., 2015]. Each written rule creates its own reaction aimed at legitimately evading the consequences of the rule, often in the form of transaction innovation. Accountants can influence classification of transactions but have no say in the choice of transactions an organization engages in. Lack of precision in social norms has an advantage over specifics of the written rules — the standard operating procedure of administrative agencies.

### 3.7 Self-regulation

Self-regulation allows a profession or industry to create and operate its own system of regulating the behavior of its members and the quality of their goods or services. Such organizations exist across many parts of the economy to set standards, monitor quality and performance, and take punitive actions when necessary. Self-regulatory organizations tend to be more effective in creating coordination standards which become largely self-enforcing. If the Association of American

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<sup>6</sup>Sivakumar and Waymire [2003] find interesting interaction under pressures of enforcement between conservatism in financial reporting and rates set by regulatory commissions.

Railroads were to set a standard for rails to be placed one meter apart, it is in the interest of virtually all railroads to conform to the standard, even if they have not participated in setting that standard.

The same is not true of quality standards, because individuals have incentives to cut corners by free-riding on industry reputation, especially if the quality is not easily observable to their customers. For this reason, self-regulatory organizations tend to be concentrated in coordination work, and government standards play a stronger role where quality is concerned [see [Jamal and Sunder, 2014](#)].

Over its 80-year history, the US SEC has encouraged the creation of self-regulatory organizations in financial reporting and relied on them to a significant degree. In its early years, the SEC let the American Institute of Certified Public Accountants — a professional association — set the financial reporting standards through its committees such as the Committee on Accounting Procedure (CAP) and the Accounting Principles Board (APB). In 1972, the APB was replaced by a new self-regulatory structure in which Financial Accounting Foundation (FAF) oversees Financial Accounting Standards Board (FASB) and Government Accounting Standards Board (GASB). They have broader representation from outside the accounting profession which nevertheless retain the majority of seats in the FASB. These organizations work closely with the SEC's Chief Accountant's Office, and rarely issue rules without prior consent of the latter. Under this arrangement, following the preparers' continual demands for clarification and guidance, the body of written rules that are now supposed to constitute the "Generally Accepted Accounting Principles" has grown to thousands of pages.

### **3.8 Markets**

In the absence of externalities and with sufficient competition, markets offer an efficient solution for the problem of producing and allocating private goods.<sup>7</sup> Information contained in published financial reports has both the zero marginal cost and the nonexcludability properties of

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<sup>7</sup>Private goods are defined in contradistinction to public goods (zero marginal cost of producing additional units and nonexcludability of the nonpayers from the

public goods. The cost of producing these reports includes two parts. The first is the out-of-pocket cost of preparing the reports from the transactions database (which the organization must maintain in any case for managing its operations and exercising internal control). Perhaps a larger cost takes the more difficult to quantify form of regulatory compliance, and the changes in behavior of management induced by financial reporting regulations. Consideration of these public goods aspects of financial reporting information points to addressing it as a collective choice and not as a private choice problem.

As discussed earlier, entrusting the problem to collective choice mechanisms — legislatures, courts, referendums, regulators, and markets — does not resolve the difficulties of identifying better reporting methods. However, one can conceive of a system of competition among alternative sets of rules by which markets operate (e.g., stock exchanges, environmental regulations, educational systems, etc.) These alternative sets of rules can be made into private goods by demanding a fee or tax from those who choose to participate in them.

### **3.9 Summary**

In selecting a financial reporting regime, technical expertise is important but not sufficient. We need to consider both social efficiency (a technical matter) and distribution of wealth (a political matter). In political matters, people can differ without any one being wrong. The quasi-judicial structure of the FASB, combined with its technical staff, imparts a technical flavor to its task and for many years the FASB remained reluctant to recognize the political (i.e., distributional) aspects of its decisions. The IASB, consisting of representatives chosen from specific countries is less cagey about acknowledging country-specific interests. A legislative system shifts the emphasis towards the political considerations, although the members of any structure for selecting a financial reporting regime must still maintain a high level of technical competence.

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benefits). The limited concept of efficiency used here does not include consideration of distribution and fairness.

Formal participation of neutral parties belonging to classes without any identifiable political interests in standard-setting bodies tends to detract from the political aspects of the task. Such individuals need not be voting members of the boards and still provide valuable advisory and technical support as members of the staff.

No standard is indispensable. People can and do live without comprehensive written standards in all domains of life. They adjust their behavior to the status quo, and issuance of a standard, however well-meaning, can inflict harm. For example, it has been argued that the adoption of mark-to-market valuation and incurred loss method of recognizing bad debt expense in the financial services industry contributed to the Atlantic Financial Crisis of 2007–2009.<sup>8</sup> The performance of a standards organization cannot be measured by the number or the pages of standards issued any more than the success of a legislature can be judged by the volume of legislation. There is not even an approximate connection between the two. Is an active parliament a good parliament? Is an active standard setter a good standard setter? There is little reason to carry the positive image of “proactive” behavior from the personal to this institutional domain [Sunder, 1981; Madsen, 2011, 2013].

The refusal of a standard-setting body to issue aggressive standards means delay in standardizing the treatment of newer types of business transactions and events. It is no more reasonable to expect that accountants can immediately come up with efficient standards for newer types of business transactions than that physicians can immediately find a cure for newly discovered diseases or that engineers can fix a design weakness overnight. The imperfection of our knowledge generates the necessity to conduct field testing of a variety of solutions to new problems. Forcibly speeding up the process imposes the large costs of making mistakes, changes, and resultant confusion in financial markets. Accountants who worry that the Securities and Exchange Commission may not accept a slower pace of response to new issues need only recall

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<sup>8</sup>See Hellwig [2008] for a broader analysis of this financial crisis.

the consequences of the SEC's poorly conceived and ultimately unsuccessful intervention with the oil and gas reserve recognition accounting in the 1970s.

No matter what institutional mechanism we devise to set an accounting regime, our ability to identify socially superior solutions will remain limited and imperfect. We cannot observe other people's preferences; people's preferences depend on what they know and their past experience, which change continually. When new solutions or rules are implemented, people adjust their behavior to the new situations. Therefore, an understanding and observation of how people change their behavior in response to new standards is indispensable to devising a socially efficient reporting regime. The more aggressive a rule is, the less likely it is that we have a reasonably good *ex ante* understanding of its consequences. Perhaps the practice-based orientation of accounting regimes deserve more attention.

As we move from common law towards bureaucratic mechanisms, fewer people are directly involved in making decisions. More of the power of an organized state is brought to enforce the decisions, decisions can be made and enforced more expeditiously, and the chances of making errors increase. Historically, this has been the direction of change in the United States and the European Union in recent decades. Given the prevailing level of dissatisfaction with the financial reporting regime, we should consider where we might have gone wrong in conceptualizing the meaning of better financial reporting, and the means of achieving that end. The following three sections explore three major approaches — rules, norms, and institutions.

# 4

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## Standards and Rules

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After a brief review of the economics of standardization, I discuss the problem of identifying better standards and the comparison of accounting standard setting with the standard setting process in four technologically oriented organizations. A brief history of accounting rule-making in the US concludes this section.

### 4.1 Economics of standardization

It is costly to keep inventories, to gather and process information, and to negotiate contracts. The desire to cut these costs motivates standardization. This is true of electrical adapters to fit wall outlets, the 110-V household power supply, and thousands of articles of daily use and means of communication such as language, phone, and internet. Without standardization to facilitate coordination, modern life would be cumbersome if not impossible.

Coordination standards are concerned with the mutual fit among components of a system — the shape of threads of a bolt and the nut, the electrical bulb and socket, the side of the road cars drive on, etc. In all of these cases, the specific choice is less important than the

coordination among the parts. In Jamal and Tan's [2010] experiment, the best accounting was found to occur when standards type and auditor type are mutually consistent (either both are principles-based, or both are rules-based). The argument for consistency and comparability, as well as the attempt to create a uniform definition of assets and liabilities, are coordination arguments for accounting standards [Jamal and Sunder, 2014]. Financial reporting standards can also be supported by the presence of network effects (the marginal increase in the utility of a product for a user as the number of other users changes; Katz and Shapiro, 1985; Ferrell and Saloner, 1985).

Quality is a second motivation for standardization. Quality standards prevent many people from performing surgery, cutting hair, or teaching accounting, and are often justified on the grounds that they are meant for the protection of the uninformed patients, customers, or students, respectively, who may find it costly or impossible to discriminate between the competent people and the crooks. These standards, the argument goes, protect the weak and enhance social welfare by promoting mutual trust and reducing the need for investment in gathering private information.

Quality standards specify a minimum for each attribute of the product category, such as percent of foreign material or impurities, strength, probability of failure, chances of defects, fat content, and smoothness. They may also specify various grades for the product [see Jamal and Sunder, 2011a,b]. Sellers can save money in the short run by cutting corners on quality, and buyers prefer higher quality, making it important to include the relevant quality standard in commercial contracts.

With the benefits of standards come costs, which limit the extent of standardization, and lead us to have many different models of cars, computer languages, types of doctors, and even types of electrical outlets [Krislov, 1997]. Four broad categories of costs are: (1) the direct costs of formulating and implementing the standards, (2) the cost of "imperfect fit" for those whose needs would be better served by an alternative to the chosen standard, (3) the potential use of standards to create monopoly and discourage competition, and (4) making experimentation, learning, and innovation more difficult.

Both the costs as well as the benefits of standards can be significant. However, the excess of total benefits over total costs does not necessarily produce a cost–benefit efficient outcome. When even small aggregate direct costs are concentrated among a few, they are willing to spend resources and organize to prevent such an outcome. Conversely, even larger aggregate benefits may be thinly distributed over a large number of parties, and such parties have little incentive to organize and lobby for such beneficial outcomes. Since it is difficult to collect the contributions from a distributed population of beneficiaries, such work is done either by government or industry consortia. Only a small number are willing to pay a significantly higher price for a custom-fitted suit or custom-designed home instead of buying a standardized product off-the-shelf. Antitrust case against Microsoft Corporation’s attempt to standardize its Internet Explorer software with Windows computers, and the benefits that came from proliferation of competing browsers is an example of anticompetitive costs. Standardization of the QWERTY keyboard in practice has shut out DVORAK and other more efficient keyboard layouts from gaining a foothold in the market place.

## **4.2 Problems of identifying the social optimal**

In spite of a considerable body of theoretical work on the subject (see [Bertomeu and Magee, 2015a,b](#) and citations in these articles for examples), the scarcity of reliable data on relevant parameters of the problem make it difficult to solve optimal social choice problems in accounting. The uneven distribution of costs and benefits of standards render it difficult to determine which standards are socially desirable. The cost–benefit criterion (total benefits exceeding total costs) ignores the distributive effects. Pareto criterion (choosing an option which is better for at least some people without being worse for anyone) is difficult to apply in practice. It is not easy to think of a law, rule, or standard that hurts nobody. Social choice mechanisms discussed in Section 3 often end up settling on some compromise between efficiency and distributive concerns.

The practical task of identifying which one of the proposed alternatives best satisfies the chosen criterion is nontrivial because the



decision makers do not know the private preferences, and the attempts to discover them are fraught with strategic problems. When we ask people what standard, if any, they prefer, they may not know or they may not be willing truthfully to reveal what they prefer. Active participation in the process of standardization is also biased in favor of those who have large potential gains from such participation, or have relatively small costs of organizing groups with common interests to participate. Cost–benefit analyses are difficult to do; while some of the costs may be estimated, benefits of standards can be too diffused to be quantified.

### 4.3 Monopoly or competition in standard-setting<sup>1</sup>

Many arguments have been made about the advantages of monopoly or competition in setting financial reporting standards [see [Dye and Sunder, 2001](#); [Sunder, 2002a, 2010a, 2011a](#)]. Although regulators in some countries (e.g., Canada, Switzerland, and the United States) allow limited competition in special circumstances, most accounting research accepts that monopoly serves public the interest [[Cooper and Sherer, 1984](#)]. Despite predictions of a race to the bottom under competition [[Barth et al., 1999](#); [Merino and Coe, 1978](#); [Previts and Merino, 1998](#)], empirical studies of regulatory competition in e-commerce [[Jamal et al., 2003, 2005](#)] and a baseball card grading market [[Jamal and Sunder, 2011a](#)] failed to find such a race.

Direct empirical examination of the arguments has been difficult because virtually all jurisdictions operate accounting rule-making monopolies in the United States as well as other parts of the world. [Jamal and Sunder \[2014\]](#) go outside the domain of accounting to compare the standard setting processes of the FASB/IASB with the processes of four technology-oriented standard setting organizations<sup>2</sup> (SSOs) with respect to the number of standards, role of government, financing, adoption thresholds, and competition.

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<sup>1</sup>Most material in this section originally appeared in [Jamal and Sunder \[2014\]](#).

<sup>2</sup>Internet Engineering Task Force (IETF), Institute of Electrical and Electronics Engineers (IEEE), Alliance for Telecommunications Industry Solutions (ATIS), and International Telecommunications Union (ITU). See [Goralski and Kolon \[2000\]](#).

By the number of standards, FASB is a relatively small player.<sup>3</sup> Government participation ranges from total [International Telecommunications Union (ITU) being an international body of national government representatives] to none [Internet Engineering Task Force (IETF)]. While Alliance for Telecommunications Industry Solutions (ATIS) and ITU provide their standards for free on the internet, ATIS and the Institute of Electrical and Electronics Engineers (IEEE) sell their standards. FASB sells access to its standards to institutions, provides free access to students and academics, and receives tax revenues since the enactment of Sarbanes–Oxley legislation. Private Standard Setting Organizations (SSOs) are often financed by fees from members who have a direct interest in their standards. Adoption thresholds are the majority (FASB and ATIS), 70% (ITU), 75% (IEEE), and a rough consensus without formal voting at IETF. Unlike the FASB, all four technology SSOs face competition.

Jamal and Sunder [2014] conducted a case study of internet telephony to assess the role and consequences of competition in standardization. Their results (see Table 4.1) show that a group of IETF volunteers competing with the incumbent government-sanctioned monopoly of ITU transformed the telephone industry through highly efficient standards. With its 191 fee-paying members, a long history since 1863, and a proven track record in enabling the development of a reliable global telephone system, ITU was a success story by almost any measure. It had responded to rapid technological changes by developing a circuit switched network. Yet a revolutionary alternative architecture (packet switched network) was developed by a competing standard setter (IETF) that had no government support, power to sanction, or method to enforce its standards. The IETF succeeded not by trying to harmonize with the ITU’s model, but by having the decentralized creativity of a loosely organized group of volunteers conceiving of and designing a better “mousetrap.” Even when the incumbent SSO monopoly was doing well, a better set of standards could arise from a competitive regime because competition had not been foreclosed in

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<sup>3</sup>But it is necessary to exercise care in comparing the efficiency of standardization on the basis of the number of standards across diverse domains.

advance. Given its formal structure, legacy, and billions in sunk costs by telecom companies, it is unlikely that ITU-T (ITU's Telecommunication Standardization Sector) and the telecom industry would have ever made the leap to an internet infrastructure without the presence, competitive pressure and insight of the IETF [[Schulzrinne and Rosenberg, 1998](#)].

The United States and the European Union have adopted a monopoly process for developing financial reporting standards almost by default, and with little debate on the merits of monopoly and competition. The consequences of this foreclosure of competition deserve some scrutiny.

#### **4.4 Standard-setting in the United States**

In the United States, the Accounting Principles Board (APB), created in 1959 as a senior committee of the American Institute of Certified Public Accountants, followed a quasi-legislative<sup>4</sup> model with some 21 part-time members. Although mostly consisting of professional accountants, it had some representatives from corporate, investment and academic communities. Like other legislatures, the Board acted by a majority vote.

The Wheat Commission appointed by the AICPA in the wake of the investment tax credit fiasco blamed the dissatisfaction of some people with the performance of the APB on the lack of independence of its members and proposed its replacement by a quasi-judicial<sup>5</sup> structure of the FASB which, however, retained the unbalanced representative character of the APB. When constituents who did not like its pronouncements complained, the FASB had little defense except to fall back on the judgment of its members. Legislative bodies do not have

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<sup>4</sup>The Merriam-Webster dictionary defines quasi-legislative as “having a partly legislative character by possession of the right to make rules and regulations having the force of law”; or “essentially legislative in character but not within the legislative power or function especially as constitutionally defined.”

<sup>5</sup>The Merriam-Webster dictionary defines quasi-judicial as “essentially judicial in character but not within the judicial power or function especially as constitutionally defined.”

to defend their actions; their representative character and the partisan attitudes of their members serves as their protective cover. The AICPA's insistence that a clear majority of the members of the FASB be drawn from the ranks of practicing CPAs deprived the FASB of this defense.

The first eight years of the FASB were characterized by rapid standard setting, a willingness to recommend previously untried methods of accounting as exclusive standards, and a decline in constituent support. It was difficult for the FASB to refuse to issue standards on accounting matters brought before them. The guaranteed support of the disciplinary mechanism of the AICPA for noncompliance with the standards may have reduced their concern for acceptability by the constituencies. Their staffing had to be justified by sufficient output of new rules, which also generated the revenue from the sale of publications to support them. The annual report of the FASB consisted of lists of projects completed and pronouncements issued as measures of performance. The atmosphere of bias in favor of action led in 1977 to relaxing of the voting requirements to a simple majority of four instead of five out of seven. The Board recommended application of complex new accounting methods which had not previously been tested in the field, and whose consequences were not well understood. FAS 8 (foreign currency translation) and FAS 19 (oil and gas exploration costs) are examples of such actions.

In the 1990s, the FASB joined the International Accounting Standards Board in a project to converge in the direction of a single set of "high quality, principles-based" accounting standards for the world. The basic difficulties of justifying and achieving such a goal, combined with the reality check provided by the global financial crisis of the recent decade, has led to abandonment of that project. After some 45+ years, and many important achievements such as accounting for pensions and other post-retirement benefits, the organization appears to have settled in with a more modest vision of the improvements in financial reporting that can be achieved through standardization.

Table 4.1: Process description of five standard setting bodies in the United States as of February 18, 2008.

| Standard Setting Organization (SSO) | Financial Accounting Standards Board (FASB)        | Internet Engineering Task Force (IETF)                                     | Institute of Electrical and Engineers (IEEE)  | Alliance for Telecommunications Industry Solutions (ATIS)                        | International Telecommunications Union (ITU)            |
|-------------------------------------|--|--|---|--|---|
| <b>Scope of standards</b>           | Financial Reporting (GAAP)                         | Internet: above the wire and below the application (e.g., IP, TCP, e-mail) | Aerospace, telecom especially networking electric power, consumer electronics, and Internet | IT in telecom industry such as plant infrastructure, wireless, multimedia        | Global telecom network standards                        |
| <b>Year formed</b>                  | 1973 Predecessor bodies: CAP (1939) and APB (1959) | 1986 Predecessor Body: Arpanet 1969  | 1963 Predecessor bodies merged in 1963: AIEE (1884) and IRE (1912)                          | 1993 Predecessor body: (ECSA) 1983–1993  | 1865  |
| <b>Working groups</b>               | 12   | 124  | 102   | 24   | 14  |
| <b>No. of standards</b>             | 168  | 7136   | 1534  | 1224+  | 4000+   |
| <b>Government involvement</b>       | Yes — Private SSO, but standards required by law   | No   | Partial — sets private and government-backed (ANSI) standards and works with ITU            | Partial — sets private and government backed (ANSI) standards and works with ITU | Yes — UN body of National (Government) Standard Setters |
| <b>Sanctions for noncompliance</b>  | Yes from SEC                                       | No   | No  | No   | No  |

(Continued)

Table 4.1: (Continued)

| Standard Setting Organization (SSO) | Financial Accounting Standards Board (FASB)   | Internet Engineering Task Force (IETF)  | Institute of Electrical and Electronics Engineers (IEEE)  | Alliance for Telecommunications Industry Solutions (ATIS)   | International Telecommunications Union (ITU)  |
|-------------------------------------|---|---|---|---|---|
| <b>Membership</b>                   | No direct members   | 65,000 Individuals and 150 organizations  | 425,000 Members in 160 countries  | 300 Corporate representatives   | 193 States who can vote, over 700 private sector members with no vote                     |
| <b>Funding</b>                      | FAF collects a tax from companies (as per SOX) based on their equity market capitalization (67% of budget) Sale of publications (33% of budget) | Individuals and organizations pay membership fee to Internet society. Individuals can also be "free" (global) members. Most funding comes from companies, and various nonprofit organizations | Individuals and organizations pay membership fee  | Companies pay membership fee (from \$1000 to \$259,000 per year) based on sales, and a standard committee fee   | Each country pays membership fee of 63,600 Swiss Francs per year                          |
| <b>Standards initiated by</b>       | FAF and reviewed by FASAC (Advisory Council)  | Grassroots members or Area Director (AD)  | An IEEE-approved organization must sponsor a standard by filling out a PAR form (Project Authorization Request) | An issue Champion-an ATIS member or a forum or committee participant must fill out an issue identification form | Member states, and other duly authorized entities (national SSOs or individual companies) |

(Continued)

Table 4.1: (Continued)

| Standard Setting Organization (SSO) | Financial Accounting Standards Board (FASB)   | Internet Engineering Task Force (IETF)  | Institute of Electrical and Electronics Engineers (IEEE)  | Alliance for Telecommunications Industry Solutions (ATIS)  | International Telecommunications Union (ITU)  |
|-------------------------------------|---|---|---|--|---|
| <b>Working groups</b>               | Full time FASB staff workers<br>Resource group of external participants set up to provide advice<br>Agenda and minutes online | Create public mailing list — number and diversity of participants monitored by AD<br>Agenda and minutes online<br>Create a document called Internet Draft (I-D) | prepares a draft of the proposed standard   | Post the issue's initial closure resolution on the ATIS Web Site and send to e-mail list<br>Resource group of external participants (CIO Council) set up to provide advice | Review the text of the draft<br>Recommendation<br>Assess the summary statement in terms of its completeness and intention<br>Debate to approve the Recommendations. |
| <b>Exposure draft</b>               | Written exposure draft. Public given minimum of 30 days to respond  | Last call issued by IESG with 4 weeks for outside input   | Each member of the IEEE-SA Standards Board places a final vote on the submitted standard document | An issue is automatically placed into final closure provided: 21 calendar days have passed since the issue's initial closure resolution and no new information surfaces    | The text of the draft new or revised recommendation must be available to TSB in a final edited form in at least one of the official and working languages           |

(Continued)

Table 4.1: (Continued)

| Standard Setting Organization (SSO)                    | Financial Accounting Standards Board (FASB) | Internet Engineering Task Force (IETF)          | Institute of Electrical and Electronics Engineers (IEEE)                                    | Alliance for Telecommunications Industry Solutions (ATIS)                                  | International Telecommunications Union (ITU)                             |
|--|---|---|---|--|--|
| <b>Standard adoption threshold</b>                     | >50% Votes of FASB Board members            | No voting — rough consensus as determined by AD | 75% of Votes cast, and at least 75% of working group must vote                              | Each company has one vote. Need >50% votes   | 70% of Votes cast (only government reps can vote — one vote per country) |
| <b>Can issue more than one standard for same Issue</b> | No  | Yes — though rare in practice                   | Yes   | Yes  | Yes  |
| <b>Standard duration</b>                               | Indefinite                                  | Indefinite                                      | 5 Years — automatic review or withdraw  | Indefinite   | Indefinite   |
| <b>Standards competition</b>                           | No  | Done ex-post in the market                      | Done ex-post in the market, but also sponsors some ex-ante olympic competition (experiment) | Done ex-post in the market but also sponsors some ex-ante olympic competition (experiment) | Done ex-post in the market   |

FASB, Financial Accounting Standards Board ([www.fasb.org](http://www.fasb.org)); IETF, Internet Engineering Task Force ([www.ietf.org](http://www.ietf.org)); IEEE, Institute of Electrical and Electronics Engineers ([www.ieee.org](http://www.ieee.org)); ATIS, Alliance for Telecommunications Industry Solution ([www.atis.org](http://www.atis.org)); ITU = International Telecommunications union ([www.itu.int/ITU-T/index.phtml](http://www.itu.int/ITU-T/index.phtml)).  
A more detailed (and earlier) version of this table can be accessed at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1075705](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1075705).  
Source: Jamal and Sunder [2014].



# 5

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## Social Norms<sup>1</sup>

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Historically, social norms played an important role in financial reporting. Social norms are maintained largely through an informal process of social as well as internal sanctions.<sup>2</sup> In contrast, rules require more formal enforcement mechanisms, often supported by the implicit or explicit power of the state to impose punishment. Many aspects of family, local, professional, social, national and international behaviors continue to be governed by mechanisms in which norms play an important role. Generally accepted accounting principles — originally a mere description in its plain English meaning — have since been capitalized into a proper name — Generally Accepted Accounting Principles — and the phrase GAAP has now come to primarily describe the rules and regulations issued by authorities with power to sanction those who do not comply with them. Its use in accounting methods that emerge from practice is far less frequent. How and why did financial reporting

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<sup>1</sup>The content of the section is based on [Sunder \[2005a,b\]](#).

<sup>2</sup>Social or external sanctions are measures used by society to try to enforce its rules of acceptable behavior through rewards and punishments. [Mill \[1863\]](#) distinguishes internal sanctions as the voice of conscience one may feel in one's own mind about one's own behavior.

replace social norms of corporate and professional behavior by written rules and standards?<sup>3</sup> The consequences of this transformation and alternative courses that are available to accounting and corporate governance deserve attention. Whether the transition from norms to written standards is productive and wise is an open question. In this section, we examine the role of social norms in financial reporting.

### 5.1 Nature of social norms

Social norms of a group are the shared expectations of one another's behavior held by the members of the group. Norms are expectations, and therefore inherently subjective. They are shared, which means that while individual *A* expects others to behave in the given manner, *A* also believes that others hold similar beliefs, and what applies to *A* also applies to the other members of the group. According to [Posner, 1997, p. 365]:

“By “social norm” (“norm” for short) I shall mean a rule that is neither promulgated by an official source, such as a court or a legislature, nor enforced by the threat of legal sanctions, yet is regularly complied with (otherwise it wouldn't be a rule). The rules of etiquette, including norms of proper dress and table manners; the rules of grammar; and customary law in pre-political societies and private associations are all examples of norms in my sense.”

Common knowledge of *X*, in its technical meaning, is shared knowledge among two or more people so each knows *X*, knows that others know *X*, knows that everyone knows that everyone else knows *X*, ad infinitum. Wearing a coat and tie by men in an office is a social norm if, even in the absence of formal rules and enforcement process, and in the presence of available and convenient alternatives, men do in fact

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<sup>3</sup>Although in some literatures useful distinctions are drawn among rules, regulations and standards, in the context of financial reporting these terms — especially rules and standards — are used interchangeably so often that it seems best not to try to draw fine distinctions to separate them from one another.

wear a coat and tie and expect others to do the same. In this sense, social norms or conventions are indistinguishable from the culture of the group [Sunder, 2002c; Richerson and Boyd, 2004; Shiller, 2005].

The object of norms is behavior, not beliefs — which means that it is always possible for an individual A to judge, subjectively, if the observed behavior does or does not conform to the norm. Social norm is a consensus — mere majority is insufficient to support it and unanimity is unnecessary. It is also incompletely specified. Like dictionaries and handbooks of manners, individuals or groups may compile and share their own understanding of the norms. Such compilations may receive attention, respect, even authority, depending on how well they appeal to the members of a group. Norms have no other authoritative source.

## 5.2 Accounting norm: An example

Recognizing revenue when essentially all that needs to be done to earn it has been done, and when the consideration in exchange has been received or is reasonably certain to be received, is an accounting norm. Managers, accountants, and students of accounting share the expectations that businesses recognize revenue in this manner. This norm, like others, is inherently subjective. Each individual can decide, after looking at a particular case of revenue recognition, whether it conforms to the norm. In a given instance, unanimity may not be achieved; consensus is the most one could hope for. A complete specification of all necessary and sufficient conditions for revenue recognition norm is unnecessary, as well as impossible. Like other social norms, there can be no authoritative source of accounting norms either, even as individuals and groups remain free to provide their own statements of what the norms are.

For example, Paton and Littleton [1940] use “Standards” in the title of the book, instead of principles in order to avoid conveying an inappropriate level of “permanence and universality.” For our purposes, it is a statement of norms “as a personal expression from the . . . score or so men who have labored earnestly to make the preparation of this document possible” (Howard C. Greer in Forward, p. vii). The Oxford

English Dictionary is both a description of, as well as a major force in defining, the English language. Likewise, books of Emily Post and Miss Manners serve as popular and effective guides to etiquette as a social norm by maintaining a subtle balance between description and prescription. Paton and Littleton's classic work is both a description of the existing accounting practice as well as a gentle nudge to improve the practice through thoughtful persuasion. Any authority and respect such sources may command derives not from their power to punish the deviations, but from the broad acceptance by the members of their audience, and the latter's general disapproval of deviations.

It has been so long since accountants turned away from norms that the authoritative promulgation of accounting practices is often assumed to be synonymous with progress or advancement of accounting. In his *Lectures on Forging Accounting Principles in Five Countries*, Zeff [1972, pp. 1–2] wrote: “The English Institute became involved in the authoritative establishment of accounting principles perhaps more by evolution than deliberate policy . . . [I]t was not until the last month of the 1960s, however, that developments in accounting research and the establishment of accounting principles began to quicken their pace. By the outset of the 1970s, an energetic and ambitious plan was in operation.” It is easy to identify the history of accounting principles with organized efforts to produce written rules because documentary traces of such processes are more easily available for the historians; social norms, even if they are widely accepted, leave fewer footprints in the public record. We can see the evidence of norms in fiction.<sup>4,5</sup>

The long and steady journey from norms towards standards can be seen in 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

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<sup>4</sup>For examples of accounting and commerce in Chaucer and Goethe and other German literature, see Russell [1986]; Gallhofer and Haslam [1991]; Jackson [1992]; Ganim [1996]; Maltby [1997]; Parker [1999]; Evans [2005].

<sup>5</sup>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.

committee will not attempt to determine the correct or even the preferable usage where more than one is in existence.” [Zeff, 1972, p. 112].

In 1918, a reprint of a memorandum on auditing procedures, prepared by the American Institute of Accountants, and approved by the Federal Trade Commission (FTC), and originally published in the *Federal Reserve Bulletin*, was labelled “A Tentative Proposal Submitted by the Federal Reserve Board for the Consideration of Banks, Bankers, and Banking Associations; Merchants, Manufacturers, and Associations of Manufacturers; Auditors, Accountants, and Associations of Accountants.” The intent was to coordinate the evolution of a norm, 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’s recommendation against inclusion of imputed interest in cost of production, and its approval at the annual meeting of the Institute, did not become accepted as an accounting norm. The Institute went on to appoint a special committee on the standardization of accounting procedure “to consider all questions of procedure brought before it, and to make recommendations from time to time on vexed questions in the hope that ultimately there may be established something approaching uniformity of procedure throughout the country” [Zeff, 1972, p. 116]. Again, the charge suggests facilitation to develop norms, not legislation of standards. During its 11-year tenure (1918–1929), the Committee produced six reports, and none was submitted for official approval of the Institute membership.

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 the accountants of the day might have used to identify the norms of their profession. First, the pages of the *Journal of Accountancy* and perhaps *CPA Journal* served as forums for active, even feisty debates on accounting and auditing; a function largely abandoned by the accounting journals as authoritative standards pushed the norms out. During 1920–1929, the Librarian of the Institute issued 33 “special bulletins” on topics referred to them, albeit without the formal 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.<sup>6</sup> Throughout the 1920s and into 1930s, a committee of the Institute worked in close cooperation with a committee of Robert Morris Associates, an organization of bank loan officers, to respond to inquiries submitted to them.

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 or informal mechanisms by which these norms evolved and were sustained. So much wealth, livelihoods, even lives, had been lost for which the prevailing norms took the blame. The social contract was fractured; it was time to identify and punish — or at least constrain — the guilty. Politicians responded in the only way they could and introduced securities laws and regulations to replace the norms as well as private innovation as a response to adverse events.<sup>7</sup> In the following seven decades, accounting and audit failures were interpreted as evidence that norms are insufficient to effectively guide financial reporting. They were pushed to the back burner, even ignored altogether. Enron and other scandals led Congress to consider asking the SEC to make accounting rules itself, and eliminate the role of the FASB in formulating the rules under SEC's supervision. Legislated accounting standards now dominate accounting, undergirded by the belief that better financial reporting can be designed top-down through expert deliberations. The creation of institutions from 1939 to the present day in the hope of accomplishing this goal is discussed in Section 6.

### 5.3 How do norms work?

How can social norms, subjective and incompletely specified, work in the contentious environment of financial reporting where large amounts

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<sup>6</sup>In his review of *Costing Terminology*, Kitchen [1954] provides a masterful argument for resisting the temptation to issue official definitions, especially in accounting. Also see Baxter [1953].

<sup>7</sup>Also see Jamal et al.'s [2005] finding on the evolution of the US web seal market to provide assurance on privacy practices in e-commerce. Under the stricter regulatory regime of the European Union, no such marker has developed.

of money are often at stake? Norms play an important role in common law countries [Posner, 1997; Ellickson, 1991, 1998; Eisenberg, 1999]. Unlike formal rules and regulations, motivation to conform to social norms is rooted in the anticipation, or even fear, of others' disapproval of deviations from the norms. Social norms tend to become so internalized by individuals that conformity can approach a moral or ethical obligation. When sufficiently internalized, deviations become rare, and the members of the group may cut back on resources spent on monitoring conformity.

Whether such a state can be characterized as trust is not clear. On one hand, a transactional approach to trust is exemplified in Ronald Reagan's use of the Russian proverb *doveryai no proveryai* (trust, but verify) in negotiating the Intermediate-Range Nuclear Forces Treaty in 1987. On the other hand is the emphasis on reputation, confidence and faith, reflected in the phrase attributed to Vladimir I. Lenin: "Trust is good, control is better" [Seligman, 1998]. A large body of literature in psychology [Cook, 2001], sociology [Granovetter, 1985], and political science [Putnam, 1993] suggests that the key trust creation mechanisms in society are personal relationships and the social embeddedness of market participants, not legal rules and formal enforcement structures.

There is evidence from laboratory experiments that groups with greater mutual trust achieve more efficient outcomes in games that place their individual self-interest in opposition to the interests of the group [Berg et al., 1995]. Cross-sectional analyses of data from many countries also provide evidence of an association between trust and economic growth [Beugelsdijk et al., 2004]. It seems reasonable to conclude that Madoff [Bray, 2009] exploited the trust of his clients, many of them from ethnically linked organizations to defraud them at an epic scale. Promotion of incentives in management literature and in corporate practice appears to have induced behavior that has undermined public trust in the business community at large, and in financial institutions in particular.

Social-psychological meanings of trust, and mechanisms for building and maintaining it among members of a group remain the subject of debate.

## 5.4 Courts and juries

Juries routinely decide on high stakes charges of murder, assault or fraud by asking if the defendant is guilty beyond a reasonable doubt.<sup>8</sup> The law does not try to replace these norms by clear, authoritative, complete, and objective statements. The US constitution — a document that covers the entire governance system for the republic — was written in less than 5000 words. The United Kingdom does not even have a written constitution. A great part of the governance of both countries depends on norms. The stakes that accountants deal with are no higher than in courts' decisions. Yet, accountants appear intent on pursuing the displacement of norms by written rules in an endless but impossible pursuit of completeness, objectivity, and uniformity.

When a jury is asked to reach a verdict on whether the accused is guilty beyond a reasonable doubt, care is taken to minimize any conflicts of interest that its members may have. The prospective jurors are asked to reveal such conflicts, and the prosecuting and defense attorneys cull any members who may have such conflicts. Care is taken to prevent people who may be pre-disposed with respect to the guilt or innocence of the accused, and to protect the jury from unfair influences during the course of trial. When the threat of such influence exists, judges may isolate the jury to shield them. Juries are encouraged to reach a vaguely defined objective of “beyond a reasonable doubt” but are assured that their judgment itself would not be subject to second-guessing by the judge or appellate courts. Jury's verdicts may be overturned if its rules of procedure are violated, but not because it is unreasonable in someone else's judgment. If accountants and managers are to retain some elements of norms in financial reporting, they also will have to develop such trust in themselves and others, and prove themselves to be trustworthy.

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<sup>8</sup>On March 15, 2005, a jury returned a guilty verdict on all counts against Bernard Ebbers, the erstwhile chief executive officer of WorldCom, who was accused of an 11 billion dollar fraud [Belson, 2005]. Post-verdict news reports quoted a member of the jury to say that she did not believe the main prosecution witness, Scott Sullivan, but did not believe Ebbers either, and found him guilty as charged.



## 5.5 Insider trading

When the SEC decides whether or not to charge someone with violation of the ban on insider trading, the rules and structure of the Commission are designed to protect such a judgment from conflict of interest. If the Commission chooses to proceed with the charge, its judgment is subject to review by the attorneys in the Department of Justice, who themselves are protected through similar procedures. The Department of Justice may take the case to court, where the final judgment is rendered, in spite of a far-from-complete definition of “insider trading” as well as “reasonable doubt.”<sup>9</sup>

## 5.6 Constitutions

Even written constitutions cannot include all rules. Judgments of the courts in ill-defined environments are sustained by investing in them the final authority without appeal beyond the Supreme Court of the United States (and the Lords of Appeal in the United Kingdom).

In summary, government hierarchies and courts use their rules of procedures and the authority vested in them to operate effectively in incompletely and ill-defined environments. The built-in rigidities of such structures are intended to protect them from charges of favoritism but not arbitrariness; in the absence of the former, the latter appears to be a benign alternative.

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<sup>9</sup>All three levels of government — legislative, administrative, and the courts — have had a role in defining the US “law” on insider trading. The Securities Exchange Act of 1934 Section 10(b) made it unlawful to use “manipulative or deceptive” devices. SEC under Rule 10b5-1(a) interpreted Section 10(b) of the law to include “the purchase and sale of a security of any issuer, on the basis of material non-public information about that security or issuer. In December 2014, the US Court of Appeals for the Second Circuit reversed two insider trading convictions added a requirement that the tipper has to get a personal benefit of some consequence (not mere friendship) out of giving out insider information, and the tippee has to know that the tipper gave the information in exchange for the tip ([United States vs Newman](#), 2014). By placing strong evidentiary demands on prosecutors, this judgment is considered by some as a major setback for prosecutors in insider trading cases. The US Supreme Court refused to hear an appeal. Whether Congress will rewrite the law in the future is an open question.

## 5.7 Norms in accounting

Financial reports of publicly held firms are prepared by corporate managers subject to review and certification by outside auditors. Over the past eight decades, this process has been regulated by the SEC under federal securities laws, to which the Sarbanes–Oxley Act of 2002 is a recent addition. All actors — managers, auditors, and regulators — have conflicts of interests in the sense that they try to balance their personal or group self-interest against their duty and obligations to others.<sup>10</sup> For example, managers of oil companies whose compensation depends on the volume of output have continued to drill and pump large amounts of oil in spite of, and even causing, the sharp drop in prices [Dezember et al., 2016]. Auditors worry about retaining their audit engagement and being sanctioned by regulators as well as saving enough of their fees to take home and earn a living. Regulators face the difficult challenge of writing rules so the outcome of interaction among these conflicting interests aligns reasonably well with the prevailing social norms which do not remain stationary.

Accounting is often referred to as the language of business, and it shares certain unruliness of language and other social norms (see quote from Klinkenborg at the beginning of this monograph). Pro forma financial statements provide a good example. This term was well-understood to mean hypothetical financial statements prepared to include a transaction or event on an as-if basis. What would the financial statements of the entity be, for example, if it had acquired firm X, or made a major capital investment? In other words, non-GAAP earnings paint the rosy picture of performance without all the bad stuff [Brown et al., 2016, see]. In 2015, the average ratio of GAAP to non-GAAP earnings reported by major US corporations (S&P 500 companies) was 69%. Here are two financial journals on the subject:

“...the people worrying about it are mostly worrying that people aren’t worrying enough about it. But people

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<sup>10</sup>See the website of Investor Responsibility Research Center (<http://www.irrc.org>) for more research on this subject.

worry about it constantly! Obviously U.S. public companies disclose their financial results under generally accepted accounting principles, which, remember, are themselves only an imperfect man-made approximation of those companies' underlying economic reality. But the worry is that companies also disclose non-GAAP numbers that make them look better, and that they somehow bamboozle investors and analysts into paying attention only to the non-GAAP numbers and ignoring the “real” ones. But investors and analysts are constantly complaining about it, so who is being bamboozled?” [Levine, 2016, in Bloomberg].

And Ro [2016] writes:

“Currently, profits as measured by standardized accounting principles are much lower than the profits executives are spouting to their investors. And it has billionaire investors and Wall Street strategists wrestling with the possibility that much of the profit growth we’ve seen is actually just an illusion.”

All the efforts of the administrative mechanisms such as the SEC and the FASB/IASB have not succeeded in controlling the evolution of language and meaning of words in business. The same investors and financial analysts and experts who the regulators strive so mightily to protect from the misrepresentations of wily preparers seem eager to lap up the unapproved accounting numbers for the purpose of assessing companies in spite of being fully warned and informed.

## **5.8 Conflict of interest**

In preparing financial reports, professional managers are put in a conflict-of-interest position, especially when their own compensation, job retention, and reputation in the market for managerial labor is sensitive to the financial reports they prepare. In recent decades, corporations tried to solve the agency problem of aligning the incentives

of managers with the interests of the shareholders by positively linking managerial compensation to measures of performance from financial reports or their surrogates, e.g., stock prices (see [Jensen and Murphy, 1990](#); but also see [Kohn, 1993](#) for some counterarguments). Attempts to address the agency problem through larger performance-based bonuses intensified the conflict of interest in preparation of financial reports, increasing the difficulty of using incompletely defined social norms to guide financial reporting and maintain trust in its integrity.

The managerial conflicts of interest were supposed to be controlled through outside audits. The choice of public accountants as outside auditors creates a conflict of interest of its own. Since services of Certified Public Accountants (CPAs) are paid for by their client organizations, the prospects of losing the revenue can bias the judgment of the auditor, especially when the auditor operates under incompletely defined social norms.<sup>11</sup>

Until the 1970s, the existence of this conflict of interest for the auditors had been controlled by granting them the privileges of a learned profession, such as internal self-regulation and a code of ethics to moderate open competition for business among the CPAs. Unlike most other businesses, accountants were prohibited from soliciting clients and employees of other firms. With the rise of economic theories of competition and regulation, CPAs were forced to lift these barriers to competition in 1979. The quality of audit services being essentially unobservable, both ex ante and ex post, the introduction of unfettered competition resulted in lower prices, profitability, and the consequent pressure to lower the quality of audit services.

As audit firms sought to recover their profitability by selling management advisory services to their audit clients, audit services became a loss leader to get the consulting partners' foot in the audit clients' door. The promotion of competition in the market for audit services had the unintended consequence of exacerbating the auditor's existing conflict of interest, inherent in their dependence on client revenues.

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<sup>11</sup>Not surprisingly, the original draft of the Securities Act of 1932 proposed to assign the task of auditing publicly traded firms to General Accounting Office, an arm of the US Congress. Lobbying by the American Institute of Accountants persuaded Congress to entrust this responsibility to the CPAs.

In this environment of worsening conflict of interest, auditors were no more able to exercise unbiased judgment on social norms of accounting than the managers themselves. Performance-based compensation for managers raises the size and salience of their stakes in accounting methods that directly influence their take home compensation, and managers push harder on auditors to get their way. Similarly, competition in the market for audit services also places more pressure on auditors to retain their clients, especially when the latter are shopping for accommodating auditors. Pressed to defend their accounting positions without admitting their economic motives, they find it easier to demand “harder” financial reporting standards to replace the “softer” social norms.

## **5.9 Final authority for decision**

Autonomy of decision making with no opportunity for second-guessing supports the use of norms. Autonomy does not mean there are no consequences of making errors of judgment. While the decision of a jury is not subject to second-guessing, even the jurors must think about how their decision will appear in the eyes of the litigants, the media, and their own friends, neighbors, family, and conscience. The same applies to the concerns the justices of the Supreme Court must have for how citizens might regard the court, and its individual members, in light of their verdict. Neither the corporate managers, nor their auditors have the luxury of autonomy. Their judgments are always subject to second-guessing by others.

Given the conflict of interests between managers and auditors, and the consequent absence of autonomy, applying the social norms of financial reporting becomes difficult. Perhaps an outside bureaucratic hierarchy — such as the SEC — could help achieve such an end. Unfortunately, this solution is not feasible. Corporate reporting requires numerous judgments at every step of the way in deciding what numbers are entered into the accounting system of the organization. No centralized bureaucracy is capable of possessing sufficient operational information to be able to apply the social norms for preparing the financial reports of publicly held firms.

Another possibility for achieving such a goal would be to entrust the accounting function in organizations to an internal bureaucracy, charged with the pursuit of social norms, and insulated from management functions and incentives. Such an autonomous function, even if it were administratively feasible, would be subject to the informational disadvantage mentioned above. Even the Sarbanes–Oxley Act of 2002 does not recommend that the internal accounting and auditing structures of the firm bypass the CEO and CFO and report directly to the audit committee of the board of directors, or to an outside regulatory agency such as the SEC. Whistleblower programs have had little impact in nongovernmental organizations. Perhaps all these conditions have exerted their cumulative pressure to curtail the role and general acceptance of social norms in financial reporting.

### 5.10 A dictionary and an inventory of accounting

Codification is the attempt to identify, organize, and write down the existing customs, practices, and rules into a systematic collection. Normative laws are aspirational standards not yet reached. The idea of generally accepted accounting practices started out as a code in the former sense, but has over time, morphed into a normative code. These two kinds of codes differ fundamentally in their content, intent, and consequences. The former code is a collection, like a dictionary, based on the judgment of an individual or a group about the existing practices, understandings and expectations. Any authority such codes may command derives solely from the willingness of the population to accept it as a repository of the relevant norms.

Anyone can write a dictionary; the respect and following it commands is a matter of the collective judgment of its users. They may refer to it to get a better sense of what others mean when they use a word, or whether that word will be understood by others to mean what they wish to convey. Since the meaning of a word in natural languages is a social norm, it is rarely unique or precise, subject to context, and changes over time. New editions of dictionaries are published to capture such changes. Between 1952 and 1983, six editions of *Kohler's*

*Dictionary for Accountants* were published, the last one edited and renamed after Kohler died by Cooper and Ijiri [1983]. It constitutes an example of an attempt to codify the social norms of accounting. Paul Grady's *Inventory of Generally Accepted Accounting Principles for Business Enterprises* (1965) is another such example.<sup>12</sup>

In the Preface to his *Inventory*, Grady [1965, p. ix] explicitly states his mission:

As the word inventory suggests, the task was not a mission to discover new or improved accounting principles. It was rather an undertaking:

1. To discuss the basic concepts to which accepted accounting principles are oriented;
2. To establish a list or summary of the accounting principles (or practices) now regarded as essential to the fulfillment of fiduciary accountabilities of a business enterprise to persons who have invested in the enterprise or have other bona fide interest in its financial position and results of operations;
3. To present the opinions of the Accounting Principles Board (APB) and its predecessor committee and other authoritative accounting pronouncements, now in effect, analyzed in a manner reasonably related to this summary of generally accepted accounting principles; and
4. To supply the explanatory and connecting language needed to create a practical accounting codification for the use of business enterprises and certified public accountants.

Grady's intent of facilitating the formation of accounting norms through his compilation was rooted in the report of the Special

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<sup>12</sup>It is only appropriate to point out that the definition of *norm* in Kohler's Dictionary [Cooper and Ijiri, 1983] is given as "An Authoritative *standard*; a *rule*"; *standard* is "A mode of conduct of general application arising from *convention* or advocated or imposed by higher authority" while *rule* is "An order, directive, or instruction usually detailing something to be done or a prescribed operation." The Dictionary's definition of *convention* emphasizes a "rule of practice which, by common consent, express or implied, is employed. . .," and comes closest to the sense in which the term *norm* is used in this monograph.

Committee on Research Program, as modified and approved by the Council of the American Institute of CPAs, which said, in part:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles for the guidance of its members and others. This means something more than a survey of the existing practice.<sup>13</sup> It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and it should, take definite steps to lead in the thinking on unsettled and controversial issues. [Grady, 1965, p. x].

The Institute, and Grady, seemed to have in mind a kind of compilation and facilitation which might draw, but not push, people into expanding the areas of agreement — an organized effort that does more than Miss Manners, but does not go as far as Académie Française does to define, protect, control, and promote the French language.

The ideas of dictionary and inventory imply absence of unique treatments of a given event, often included in uniformity and comparability. Social norms often comprise a range of behaviors. When alternatives are not permitted, information about the differences that lead the reporting entity to choose different alternatives becomes unavailable 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 —

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<sup>13</sup>The Institute conducted and published periodic surveys of existing financial reporting practice under the title *Accounting Trends and Techniques*. This practice continues to this day and the 64th edition was published in 2010.



no light one! — would be to ensure that they did. And to see they did it fairly.

Even if companies are not allowed “the maximum freedom,” letting them choose from a small set of carefully chosen competing standards would be more, not less, informative to the readers of financial reports.

## 5.11 Norms or standards

At the beginning of the twenty-first century, few people seem to be aware of the social norm, convention, or common law approach to accounting from an earlier era, and such an approach has hardly any advocates left. While [Hatfield \[1927, pp. 537–539\]](#) cites 131 legal cases, FASB and SEC’s pronouncements have crowded the common law out of the US textbooks. The United States, followed by many others in the world, now favors the more formal legislated standards (with legal enforcement) model for financial reporting. Yet, the evidence that formal standards do any better than social norms of financial reporting remains elusive, and the case for the efficacy of enforced standards remains to be made. At the very least, we should not proceed with the assumption that standards dominate social norms. It may be better if, in the absence of evidence, the benefit of doubt goes to Thoreau’s motto: “that government is best which governs least.”<sup>14</sup>

Written standards with formal enforcement are concrete and salient. Extant standards are published, easily disseminated, specified formally with some precision, and can be cited, analyzed, and discussed line and verse.<sup>15</sup> They come into existence at a specific time, through a known

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<sup>14</sup>[Thoreau \[1849, \*Civil Disobedience\*, first paragraph\]](#): “I heartily accept the motto, — ‘That government is best which governs least;’ and I should like to see it acted up to more rapidly and systematically. Carried out, this finally amounts to this, which I also believe, — ‘That government is best which governs not at all;’ and when men are prepared for it, that will be the kind of government which they will have. Government is at best but an expedient; but most governments are usually, and all governments are sometimes, inexpedient.” Also, see [Emerson \[1844, \*Politics\*\]](#): “Hence the less government we have the better — the fewer laws and less confided power.”

<sup>15</sup>See [Fuller \[1964\]](#) and [Dworkin \[1986\]](#) for discussion of natural law theory, and [Hechter and Opp \[2001\]](#) for an overview of the sociology of norms.

and understood institutional process that may allow the participation of the constituents. 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 approval and 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 practices. Codification of standards — let us make the rules clear to all — is a frequently chosen response to calm the political waters.<sup>16</sup> 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 an extended socialization process to learn and understand [Coleman, 1990]. 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. It has been argued that strategic ambiguity may help mitigate fraud [Lang and Wambach, 2010]. 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 precisely 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, mock 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 replace market and

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<sup>16</sup>In response to 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 US accounting profession and a strong advocate of norms over standards. See footnote 4 in Section 3.

social processes with new written standards instead of relying on existing (recently discredited) norms and business practices. As [Paton and Littleton, 1940, p. 5] point out:

“Obviously, rules become individualized and tend to vary among different enterprises under the influence of different ideas of convenience, effect of alternatives, etc. Within a given enterprise they are apt to change slowly since persistence in the continuance of established rules adds materially to the ability of interested parties to interpret accounting data correctly. It would be fruitless, therefore, to attempt a codification of rules and absurd to expect the conformity of all types of enterprise to the same methods if a codification of rules were attempted.”

## 5.12 Beliefs about enforcement and effectiveness

When dentists install braces, they are meticulous in applying only a carefully calibrated amount of pressure to align the teeth. As teeth move and the pressure eases, they adjust the braces every few weeks to increase it again. Through experience, they have discovered that, beyond a certain limit, applying greater pressure simply results in increasing the resistance of the body tissue, and yields less satisfactory results.

In law, maximizing the punishment for an infringement is not necessarily the best way of minimizing the frequency or the extent of infringements. All threats of punishment elicit resistance; the greater the punishment, the greater the resources devoted to evade punishment. One may be perfectly willing to pay a \$15 fine for an expired parking meter on a city street, but a \$1000 fine is more likely to induce a visit to the courtroom with counsel.

As Hayek [1945] points out, scarcity of information in the hands of authorities, and the difficulty of gathering it, limits their ability to make efficient decisions. Imposition of large fines also restricts the flow of information about innovations in the environment it is responsible

for regulating, thus creating informational reasons for keeping the fines small.<sup>17</sup>

Over recent decades, the enforcement powers behind the accounting standards have been raised to progressively higher levels, driven by the belief that the greater the power of enforcement behind the written accounting standards, the greater the expected compliance. Starting from the professional judgment of accountants, requirements of authoritative support, conformity to written standards, internal control requirements of the Foreign Corrupt Practice Act of 1977 and the Sarbanes Act of 2002 have been added in steps. These attempts at better enforcement have been accompanied by an increase in the resources devoted to avoidance of detection and punishment of infringements. As a result, the sense of personal and professional responsibility for fair representation on the part of corporate managers, accountants and investment bankers has given way to an “anything that is not prohibited must be acceptable” attitude. Standardization of accounting over the recent decades seems to have been driven by the belief that the higher the power of enforcement behind the written accounting standards, the greater the expected compliance. There is no clear evidence in support of this belief.

Formal enforcement of informal social conventions is difficult outside a common law system. However, social relationships among business participants make it possible to create a “word-of-mouth” mechanism where feedback and reputation can be enhanced (or damaged) rapidly, and a sense of community can be formed among interested parties (see [Bernstein \[2001\]](#) on the example of cotton trade and [Shield \[2002\]](#) on diamond trade). New Internet technologies make it possible for people to significantly expand these social networks [[Delarocas, 2003](#)].

The idea of social norms works not only within countries but internationally. The human rights movement has been a major force in changing government policies in many parts of the world. The United States, so zealous in guarding its sovereignty against international encroachments, seems to be yielding to evolving international norms

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<sup>17</sup>I am grateful to Jonathan Glover for suggesting this possibility.

on the death penalty for minors and mentally disabled offenders. On March 1, 2005, the US Supreme Court abolished the death penalty for those under 18 when they committed their crimes. By doing so, “the self-proclaimed beacon of freedom in the world parted company of China, Congo, Iran, Nigeria, Pakistan, Saudi Arabia, and Yemen — the only other countries in the world that executed minor offenders” [*The Economist*, 2005]. Perhaps the US Supreme Court yielded to the pressure of slowly evolving international norms. Although the death penalty remains in place for adult murderers, the United States is still out of step with most of its friends, and may yield to international norms in the future.<sup>18</sup>

With all its apparent advantages of clarity, explicitness, and the power of enforcement, the standards approach also suffers from several disadvantages relative to the evolutionary or social convention approach to regulation. Inductively derived accounting principles (see *Littleton, 1953*, Chapter 11) have yielded ground to the idea that they can be deduced from some basic assumptions or axioms [e.g., *FASB 1978*, *Bullen and Crook, 2005*; *Dopuch and Sunder, 1980*; *Bromwich et al., 2005*].<sup>19</sup>

In the following section, we examine these issues in the context of e-commerce; much of what we have to say is also applicable to financial reporting.

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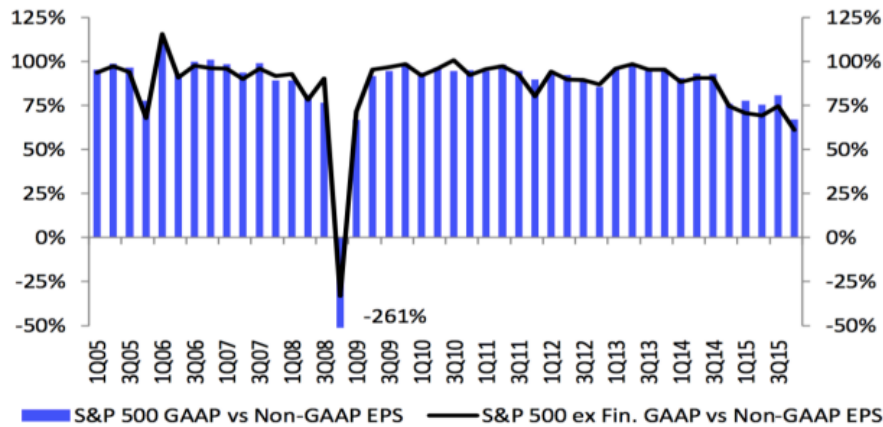
<sup>18</sup> *The Economist* [2005]: “In the Supreme Court’s majority opinion, written by Justice Anthony Kennedy, the court acknowledged “the overwhelming weight of international opinion against the juvenile death penalty.” While the court explicitly said that foreign opinions, legal or moral, are not binding in American law, they were nonetheless “respected and significant confirmation” for Tuesday’s ruling. . . . But it is not the first such case. In the 2003 ruling in *Lawrence vs Texas*, the Supreme Court struck down a state statute forbidding private homosexual conduct. The court ruled that: “Where a case’s foundations have sustained serious erosion, criticism from other sources is of greater significance. . . [T]o the extent *Bowers* [a previous case that had upheld the anti-sodomy law] relied on values shared with a wider civilization, the case’s reasoning and holding have been rejected by the European Court of Human Rights, and other nations have taken action consistent with an affirmation of the protected right of homosexual adults to engage in intimate, consensual conduct.”

<sup>19</sup> Waymire (personal correspondence) suggests that the problem may lie in the fact that most people find it harder to understand and appreciate spontaneous processes [*Hayek, 1991*]; Cartesian perspective of explicitly designed processes and outcomes is more easily comprehended.

### 5.13 Norms versus standards in e-commerce

How can we know if a switch to a regime which places greater emphasis on norms and less on standards would work? We cannot be sure, but we can learn important lessons from historical experience in accounting, as well as in other aspects of our social experience including e-commerce, drugs and alcohol abuse, and law. When visiting e-commerce sites, few people actually read the fine print of their privacy policies. Few people read the license agreements of software. As with financial reports, attitudes towards privacy on the internet hardly distinguish among sites. This tendency generates an externality among internet transactions across sites, as well as among financial analyses across reports of various firms. While the individual amounts involved in the internet purchase transactions, and the financial investment transactions may differ by orders of magnitude, the externalities in financial reporting and internet commerce have significant similarities.

The United Kingdom (and the European Union) protect the privacy of their citizens by legislating standards to be monitored and enforced



**Figure 5.1:** Ratio of GAAP to Pro Forma (non-GAAP) earnings of S&P 500 companies (with and without financial companies).

Source: Deutsche Bank, IBES.

under the powers of government.<sup>20</sup> The United States chose, through deliberation or default, to let the privacy policies in e-commerce evolve as norms or conventions without legislated standards or a punitive enforcement mechanism.

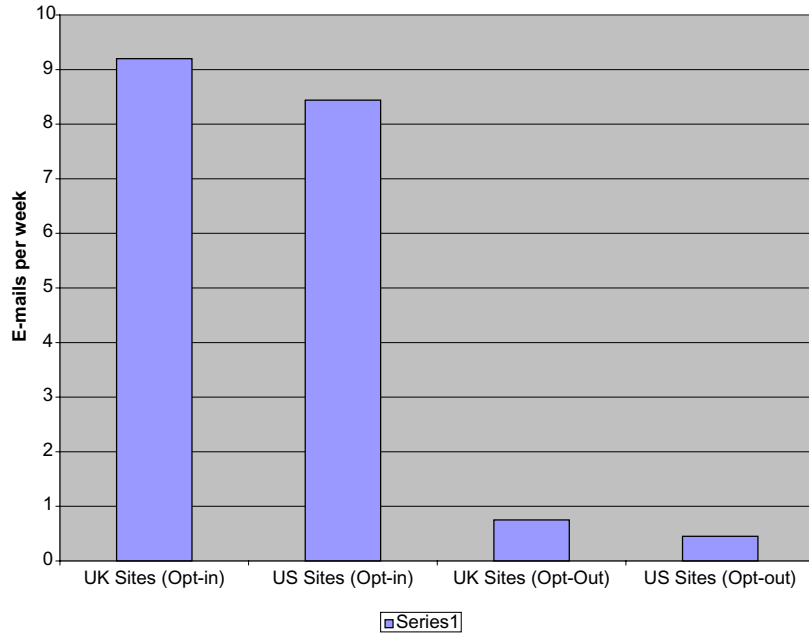
Jamal et al. [2005] compared the performance of these two regimes with respect to two aspects of privacy. They found that the number of email messages sent to those who do not give consent to receive such messages, is almost identical under the two regimes. Most e-commerce sites honor the choice exercised by the registrants. Registrants who indicate their willingness to receive commercial email messages receive a comparable level of message traffic under the two regimes (Figure 5.2).

They also report that on the notice/awareness dimension (i.e., participants receiving timely notice of an entity's information and privacy policies), the overall performance of the standards and enforcement regime of the United Kingdom is about the same as that of the evolutionary regime of the United States (Figure 5.3).

In the absence of legislated standards and their government enforcement, a market for web assurance services, including privacy assurance, has arisen in the United States. About a third of the US websites chose to pay a small fee to the sellers of such services (e.g., TRUSTe and BBB Online) and had them certify that: (1) The website policies conformed to the privately developed standards of the assurance service provider, and (2) The website practices conformed to the website's stated policies [see Jamal et al., 2003]. On the whole, the US websites that displayed the service providers' assurance seals performed as well or better than the UK websites in protecting the privacy of their users. The legislation and enforcement mechanisms in the United Kingdom and the European Union were set up on the assumption that they would help improve privacy on the Internet. Yet, the comparative study between the United

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<sup>20</sup>See United Kingdom Data Protection Act 1998 ([http://www.opsi.gov.uk/acts/acts1998/ukpga\\_19980029\\_en\\_1](http://www.opsi.gov.uk/acts/acts1998/ukpga_19980029_en_1), accessed March 14, 2016) and European Union Parliament and Council Directive 95/46/EC (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31995L0046:EN:HTML>, accessed March 14, 2016). Information Commissioner in the UK, and similar authorities in other European Union countries actively enforce their domestic and EU laws. See Organisation of Economic Co-operation and Development or OECD [2006].



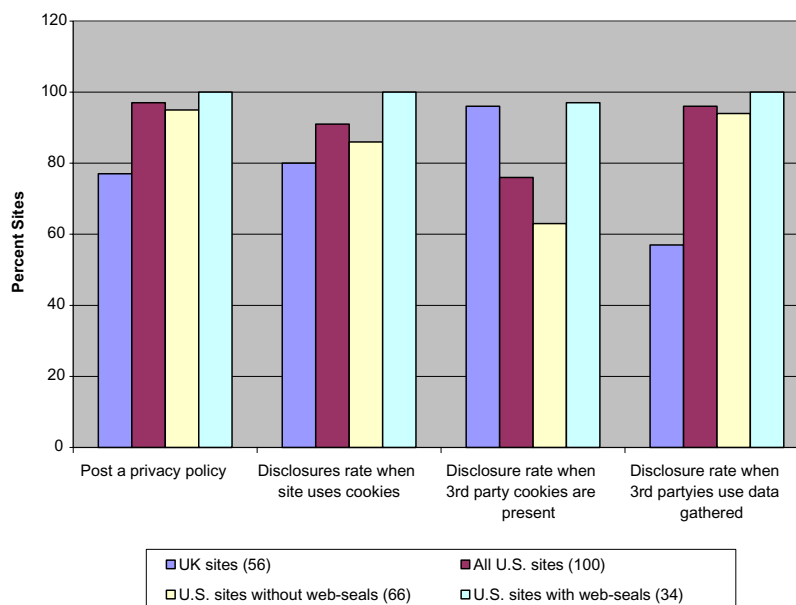
**Figure 5.2:** Average number of e-mail messages generated per week.  
*Source:* Jamal et al., 2005.

Kingdom and the United States reveals that privacy has fared no better in the United Kingdom than in the unregulated US e-commerce environment. In particular, formal regulation does not provide protection from the extreme behavior of a few websites. This is consistent with what we observe in financial reporting: Enron, WorldCom, Fannie Mae, and other companies were mired in massive accounting scandals in the most extensively regulated financial reporting environment in the world [see Abdel-Khalik, 2016].

#### 5.14 Limits of standards and rules

Laux and Stocken [2016] report an inverted-U shaped relationship between innovation and stringency of standards. When standards are too weak or absent, entrepreneurs cannot extract benefits from their





**Figure 5.3:** Notifying visitors: disclosure of privacy policies on US and UK websites.  
*Source:* Jamal et al., 2005.

attempts to innovate; when they are too stringent, they cannot innovate at all.

Legal scholarship and practice is careful in recognizing the limits of the efficacy of written rules. When it is not possible to write a rule that will improve the state of affairs compared to a judgment-based system, the law leaves the judgment in place, irrespective of the importance of the question at hand. When a judge asks the jury to determine if the accused is guilty beyond a reasonable doubt, lay jurors would want to know how much doubt is reasonable: 10%, 2%, or 1%? The law does not attempt to codify answers to such questions. Legislators and lawyers understand all too well that the consequences of clarifying such questions can be even less desirable than the consequences of leaving the answers to judgment, even when the judgment is to be exercised by laymen.

Endless clarification of accounting rules to the point of defining the percentage thresholds for materiality, lease capitalization, consolidation, and nonconsolidation of special purpose entities, makes it easier for the Wall Street bankers, accountants, and lawyers to design transactions to frustrate the intent of the standards, no matter how carefully they have been drafted. By adding new attributes to transactions, they can claim that the existing rules do not apply. Setting up accounting institutions such as the FASB and the IASB, whose primary function is to issue new accounting rules, has contributed to the tendency to write standards which are declared by them to be “generally accepted” only in the sense of “follow them, or else...” Accountants could abolish the rule-making monopolies in various jurisdictions, and introduce elements of competition among rule makers within each financial reporting jurisdiction in order to avoid this problem [Dye and Sunder, 2001; Sunder, 2002a,b].

In financial reporting, the legal requirement of an independent audit of publicly-held firms seems to obstruct efficient functioning of a market for audit services. If independent audits were not a legal requirement, firms with sufficient confidence in their accounts and in their prospects would spend the money to hire reputable independent auditors to convince their shareholders about their transparency and good prospects. Firms without such confidence will not find it worthwhile to hire such auditors because an audit will only reveal their weaknesses.<sup>21</sup> Investors, presented with reports with and without auditor certificates will have to make their own risk assessments and price the securities accordingly. Without government regulation, a market for certification or audit services would develop analogous to the US market for web services in e-commerce. Jamal et al. [2003] adduce evidence of a web

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<sup>21</sup>It is possible that a third “too cool for school” type of firm who believes itself to be so superior, and known to be superior, that it may also not bother to hire an auditor. Fortunately, it is not difficult for most people to distinguish geniuses who do not need to go to school from those who drop out because they do not understand the material. Ronen [2002] and Dontoh et al. [2013] propose that each firm could be allowed to choose how much insurance it wishes to buy to protect its investors from financial misrepresentation and fraud. Under such a system, auditing will become function of the underwriter to help it decide on the premium for the insurance policy.

certification market for privacy assurance. DeWally and Ederington [2006] analyze the evolution and functioning of an audit certification service for online comic book auctions on eBay. Instead of allowing such a market to develop endogenously, the SEC requires all firms to have their reports audited and, following the Sarbanes–Oxley Act, tries to specify (through the Public Company Accounting Oversight Board) the standards by which the auditing must be carried out. It can be argued that the extensive regulation of audit practice has been accompanied by commoditization of the audit and has contributed to the widespread auditing scandals of the recent years.

In the absence of mandated standards, US websites tend to view the disclosure of privacy policies as an instrument of their marketing strategy to attract consumers. Accordingly, they make it easy to find their statements of policy and adhere to these policies reasonably closely. UK websites, on the other hand, appear to view privacy disclosure as merely a compliance matter; they appear to be, at the very least, indifferent to consumer concerns about their privacy policies; and on average, make it more difficult than in the US for their customers to find their statements of policy.

Dye points out that in a stationary environment standards and norms are likely to coincide.<sup>22</sup> On the other hand, is it faster and less error prone for informal norms to evolve in response to the changing environment? There isn't enough evidence yet about the relative abilities of rules and social norms to respond efficiently to environmental changes. Sunder [1984, 1988, 1997] suggests stability of standards as a desirable feature of the accounting environment, other things being the same, so that people have the opportunity to adjust their behavior and arrive at a steady state if no transactions innovation occurs. However, the existence of a standard setting mechanism encourages, indeed invites, interpretive innovation as well as transactions innovation. This stimulation of demand for standards is less likely to arise in a regime

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<sup>22</sup>Personal communication. Posner [2003] suggests that following precedent tends toward efficient practice and Gennaioli and Shleifer [2005] show that while convergence to efficient rules occurs only under special circumstances, the results of following precedent are more beneficial on average under more plausible circumstances.

of evolving norms. Deviant managers and accountants would have to contend with the uncertainty of ex post resolution of whether their acts are judged to be acceptable by others. By trying to “make the rules clear” in advance, the FASB and the IASB encourage both transaction as well as interpretive innovation, paradoxically making it less likely that we shall ever arrive in a steady state of an ideal set of standards, even if the economic environment were stable.

This belief is reinforced by Cheit’s [1990] comparison of protective standards written by four pairs of public agencies and private organizations operating in the same space: grain elevators, woodstoves, aviation fire safety, and gas space heaters. He questions the economics and political science theories [e.g., Stigler, 1971; Wilson, 1980] about the relative nature and efficacy of safety standards set by government agencies and private organizations, and he finds little evidence to support any of them in the field data. He shows that hundreds of organizations, not necessarily well-known to the general public, (e.g., Underwriters Laboratories and the National Fire Protection Association) follow rigorous due process, and their standards play significant roles in regulation, directly, as well as through incorporation, into government laws and regulations. We need to learn more than we now know about the similarities and differences between standards setting in the public and private sectors.

The same regulatory space is often occupied by both government and non-government organizations with little systematic evidence on the circumstances in which one kind of standards is more desirable than the other. Kelman’s [1981] comparative study shows that two seemingly different regulatory regimes of workplace safety and health in the United States and Sweden produced surprisingly similar results. There seems to be no body of theory or evidence to guide policy makers in choosing between public and private mechanisms for a given set of standards and regulatory task.

Making a choice between 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 criteria are to be used for ranking the alternative standards. The corporate cost of capital is often mentioned in this context [see

Sunder, 2002a,b]; however, being an *ex-ante* concept, it is difficult to measure with sufficient precision. Societies that depend on norms and tradition often get stuck in inefficient solutions (e.g., slavery) and it may take reform movements, even armed uprising, to release them.

Recent research in banking [Barth et al., 2004] and securities regulation [Romano, 2002; LaPorta et al., 2003] examines the possibility of regulatory failures, especially when public, as opposed to private, enforcement is the primary instrument of regulation. In financial reporting, the Securities Act of 1933 and the Securities Exchange Act of 1934 imposed an accounting regulator (the SEC) as well as a mandatory requirement to have an independent audit. The simultaneous introduction of these two requirements can create an impression that they are mutual complements. However, without a careful examination across countries, one cannot rule out the possibility that accounting regulation and auditing may be substitutes.

Commoditization of the financial statement audit may have been sped up by the extensive regulation of financial accounting. A recent attempt by the audit profession (American Institute of Certified Public Accountants [AICPA] in the US) to distance auditing from accounting by switching to “assurance services” may have been motivated by such substitution, or by auditors’ desire to extend the scope of their services. The link between the regulation of financial accounting and private demand for auditing may not be as direct, as is often assumed in the accounting literature.<sup>23</sup>

Recent decades have seen a revival of the old debate about the degree to which financial reporting should rely on detailed rules versus broad principles of accounting. Any shift in the emphasis between

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<sup>23</sup>The AICPA and the Big 4 accounting firms failed to penetrate the e-commerce privacy assurance market, which came to be dominated by TRUSTe and BBB Online. The AICPA focused its online Web seal (WEBTRUST) on selling assurance with respect to business practices (internal control) and security, not privacy, and found that there was little demand for what they offered at their high prices. DeWally and Ederington [2006] document a thriving market for quality assurance services for comic books sold on eBay. Although eBay designated PepBoys as its official assurance provider for used cars sold on its system, the demand for this service appears to be small.

rules and principles implies a corresponding change in reliance on formal enforcement and norms of behavior. The consensus seems to be shifting toward placing more weight on principles. The findings of the [Jamal et al. \[2005\]](#) study that raise questions about the effectiveness of enforced law in enhancing e-commerce privacy can be usefully considered in this light.

Law, auditors, reputation, business norms and practices, warranties, disclosure, and industry associations are various trust-creation mechanisms associated with markets. The value of each mechanism depends on which other mechanisms are available in a particular market. Although each mechanism may be useful in isolation, the marginal value of some over others may be small. Perhaps the value of legal regulation and enforcement may be overestimated when the availability of alternative trust generation mechanisms is ignored in studies of accounting regulation. Future research can help us understand the incremental value of formal legal regulation and enforcement in situations where other trust-creation mechanisms are available.

By their very nature, social norms (and culture) are specific to the society they serve. Variations in evolved systems, like in the beaks of the finches inhabiting various valleys of the Galapagos Islands, or in wedding ceremonies in various parts of the world, are not explainable 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, especially the United States and United Kingdom. Such ethnocentricity would be rejected in most other fields of social sciences but it has remained largely unchallenged in financial reporting.

Is it possible to tame the financial reporting practices of corporations through substantial, if not exclusive, reliance on written rules and punishment for violations? Evidence from the behavior of social animals suggests that beyond their physical needs, constraints, and

threats, norms of their own society play a significant role in what they do. Perhaps it is not unreasonable to wonder if, given the importance of our own extensive and complex social structures and norms in various walks of life, ignoring them in financial reporting (by excessive dependence on written rules<sup>24</sup>) is a wise choice.

## 5.15 Engineering of social norms

Bottom-up emergence from only vaguely understood interactions among members of society has been integral to the concept of social norms. From this perspective, design or top-down engineering of social norms is an oxymoron. However, organized efforts to change social norms are probably as old as social norms themselves. We briefly explore some conceptual and implementation issues.

Who can decide what a social norm should be? The very idea of a social norm as an emergent phenomenon arising from aggregation of diverse preferences and actions of members of society places a serious question mark on the idea of designing social norms.<sup>25</sup> [Ehrig et al. \[2015\]](#) doubt if it is prudent for a liberal society to entrust the task to a social dictator as some have proposed [e.g., [Thaler and Sunstein, 2008](#)].

Individual and groups of social reformers have launched myriad campaigns throughout human history to change social norms. Like other mutations in any evolutionary process, some such efforts succeed and most are forgotten. [Bicchieri and her co-authors \[Bicchieri, 2006, 2015; Bicchieri and Mercier, 2004\]](#) have argued that social norms arise from conditional, not stable, preferences. People participate if they think that others will, and others think that everyone should participate. Even if we are able to work out the engineering of changing social norms, who shall we trust with such absolute power?<sup>26</sup>

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<sup>24</sup>See [Crook \[2015\]](#).

<sup>25</sup>See [Hayek \[1945\]](#) for his theory of markets as aggregators of information dispersed in society, and [Plott and Sunder \[1988\]](#) for empirical evidence.

<sup>26</sup>Also see [Ellickson \[1991\]](#) and [Posner \[2002\]](#) on roles of social norms and law.

Accounting practices also emerge, get tried, debated, become popular, or disappear. Regulatory institutions of accounting can play a gentle role in supporting such processes with a light touch. Overconfidence in our abilities that underlies heavy-handed regulatory interventions, of which the so-called “fair value” accounting is only one recent example, risk deteriorating financial reporting. As [Ostrom \[2000\]](#) points out, such interventions, backed by enforcement powers, crowd-out intrinsic motivation and professional judgment because of the fear of extrinsic punishment.

### **5.16 Possible reforms**

For over the past 60 years, the American Institute of CPAs (AICPA) has conducted and published the results of an annual survey of financial reporting practices of some 500–600 US companies. While these practices are influenced by the rules issued by the SEC and the FASB, reading this publication allows one to form a good idea of the prevailing social norms of accounting on aspects not yet covered by authoritative rules. How much of the financial reporting territory should be left to social norms deserves more attention of the rule makers.

In my opinion, the pendulum of corporate financial reporting appears to have swung too far in the direction of written rules. Debate about principles-based standards during the past two decades may be a consequence of this realization. However, the FASB/IASB’s penchant for top-down prescriptions over emergent practices, and for pursuit of yet-to-be-defined “high quality” of the “principles” stands in the way. Perhaps it is time to achieve some shift in emphasis of financial reporting from standards towards social norms by addressing the above-mentioned factors.



# 6

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## Institutions<sup>1</sup>

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We can think about institutions of accounting at organizational, structural, and expectations levels. Organizations such as the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB) and the Public Company Accounting Oversight Board (PCAOB), and National Association of State Boards of Accountancy come to mind. The presence and functioning of such institutions is seen in their charters, buildings, employees and other active participants, budgets, procedures, and activities. Structural institutions exist at a more abstract level such as business corporations, the accounting profession and higher education in the US. Structural institutions consist of operating relationships among many organizations and individuals defined and governed by law, regulations, social norms, technology, and preferences.

At a higher level of abstraction, expectational institutions come into view. For example, family, citizenry, marriage, language, festivals, and religion are labels assigned to certain expectations and observable and recurring patterns of behavior in societies. They also are called institutions in a third sense of the term. This three-way classification

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<sup>1</sup>The content of this section is based on [Sunder \[2003\]](#).

of institutions is hardly mutually exclusive, but little would be gained by attempting a more precise delineation of boundaries to separate them. In discussing social norms in Section 5, we have already covered expectational institutions. The present section focuses on structural and organizational elements of institutions.

## **6.1 Evolution**

Accounting and auditing are important components of the corporate institution that evolved over four centuries since the Dutch and the British East India Companies were chartered [Dobija, 2015]. These companies grew to become joint stock companies in order to gather large amounts of capital from investors to finance trade with the rich countries to the East along the newly discovered oceanic routes.

When a person entrusts his wealth to another in the hope of benefiting from the latter's investment expertise and skills, the risk of malfeasance comes with the prospect of returns. These companies, too, faced this agency problem, and experimented to find a satisfactory arrangement to balance the interests and incentives of the principals and the agents. Institutions of accounting and auditing evolved to support the function of organizations. Reports of continuing malfunctions show that the solutions developed are far from perfect, even unsatisfactory [Peterson, 2015]. I examine some possibilities for reforming the institutions of accounting to do better.

## **6.2 US Corporate accounting**

Consider four main elements of the US system — accounting rules and their enforcement, organization to set accounting rules, audit requirement along with a mechanism to control the quality of audit work, and the involvement of the board of directors in audit and financial reporting of the firm. A fifth element — executive compensation — is also crucial for the analysis of institutions of corporate accounting.

Managers of publicly held corporations and not-for-profit organizations have to prepare, publish, and vouch for their financial reports, at least once a year. Allowing some discretion in content and format,

these published reports are required to be supported by a system of accounting and internal controls to safeguard the resources of the organization. In addition, the reports must meet some minimum standards of format, disclosure, detail, definitions, and measurement. We refer to all these as accounting rules. Subjecting these reports to auditor and regulatory scrutiny for compliance with the rules constitutes most of the enforcement, with occasional intervention by courts of law.

The statutory authority for setting the accounting rules lies with the Securities and Exchange Commission, an independent regulatory body set up by the government to implement acts of Congress. The SEC lets the FASB, a tax-financed private organization, do the detailed work of developing standards through a laborious process, and retains a right to veto its outcomes. Publicly held corporations are required to follow these accounting rules through the statutory enforcement power of the SEC.

The SEC also requires that the financial reports be certified by CPAs to fairly present the company's financial status and performance. The CPAs who do not have a reasonable basis for issuing such a certificate risk being held liable to the shareholders for negligence. The AICPA's elaborate rules to guide its members in their audit work were replaced in 2002 by Public Company Accounting Oversight Board (PCAOB) created by an act of Congress. PCAOB also oversees the functioning and disciplining of audit firms.

The New York Stock Exchange requires that a majority of its listed firms' board members be independent and not employed by the corporation. It also requires that the audit committee of the board consist of independent directors who supervise the appointment and work of the outside auditors. Field observations, however, reveal major disparities between these requirements and actual practice [see [Fiolleau et al., 2013](#)].

A large part of the compensation of corporate executives is contingent on corporate performance as measured by accounting numbers (e.g., income, sales, and the rate of return) or returns on equity. In the 1990s, the granting of stock options was a popular form of contingent compensation, its popularity fuelled by the sharp rise in the stock market and an accounting rule that excluded the economic value

of incentive options granted to employees from compensation expense recognized in the income statement. The magnitude of the contingent compensation can be large, and in some cases it reached hundreds of millions of dollars for one person for one year. The dotcom bust in the stock market in year 2000 took some shine off the stock options and a change in accounting rules (FAS 123R) in 2006 made restricted stock and performance stock more popular than stock options. In 2014–2015, performance stock, restricted stock, and stock options account for approximately 50%, 25% and 25%, respectively, of the equity based compensation.

The decisions about executive compensation are made by the compensation committee of the board of directors consisting of members who are supposed to be independent of management. But typically, these “independent” members of boards depend on the goodwill of the CEO for their own compensation, perks, and re-nomination to the slate presented to shareholders for their vote.

This rough outline of the accounting institution for business corporations can be used as a point of departure to explore the feasibility and consequences of alternative structures.

### **6.3 Accounting rules**

Until the early 1970s, general acceptance was the dominant accounting paradigm. Like natural languages, where the meaning arises from general acceptance, accounting was thought to evolve gradually through usage, analysis, discussion, and soft recommendations over time. The multiple shades of meaning associated with each word and the multiplicity of words to convey various shades of a given meaning, endow natural languages with flexibility and depth of expression. Natural languages have their grammar and dictionaries written by those whose authority is derived not from their power to sanction, but from the recognition of their expertise. No natural language is known to have been designed by people through a deliberative process; Esperanto, created to become the universal language, has languished in obscurity [Fearnley and Sunder, 2006].

Since the creation of the SEC, the evolutionary spirit underlying the general acceptance tradition has been de-emphasized in favor of designing accounting rules through a deliberative process, and enforcing them through sanctions. The efforts of the Committee on Accounting Procedure (CAP) during 1939–1959 were modestly labelled as *Accounting Research Bulletins*, implying that they were tentative suggestions at most, of some experts who had researched the matters. While the intent of CAP was clearly to nudge the evolution of GAAP, and perhaps even codify some of the extant accounting practice, the labels of the Committee as well as its writings were modest about the importance, abilities, and attention they deserved.

After some 20 years, the Accounting Principles Board (APB) and its *Opinions* replaced the CAP and the research bulletins. Stepped up assertiveness is reflected in the name of the organization — a board that identifies the principles, beyond conducting just research. However, it stopped short of claiming anything more than the label of *Opinions* for its endeavors. While these *Opinions* carried significant weight, they left room for others to have different opinions. Indeed, in practice, CPAs could and did deviate from the published *Opinions* of the Board without risking sanctions when they thought it appropriate for fair presentation in the financial reports of their clients.

The failure of the APB to gain general acceptance for its *Opinions* on accounting for investment tax credits led the SEC and the accountants to infer that more authority to back up the accounting rules would solve the problem. They created the FASB to issue *Financial Accounting Standards*. Corporations and CPAs were required to adhere to these standards or risk sanctions and penalties. Armed with a permanent establishment and a significant budget, the FASB ventured forth to pronounce the rules that corporations and CPAs have been required to follow. The authority vested in the new body discarded the idea of general acceptance; its seven members were to decide on the accounting rules after analysis, research, and consultation.

The FASB listed many criteria for the selection of its accounting rules in its *Concepts* statements, many of them in conflict with one another. An aggregation function, or a method to resolve these conflicts was missing from *Concepts*. The Board set up an elaborate and good

faith consultative process to elicit suggestions, comments, and advice from its constituents before making its pronouncements. Unfortunately, the authority vested in its pronouncements deprived them of the evolutionary characteristics necessary for general acceptance implicit in living languages.

Instead, the existence of the FASB became an instrument for auditors to supersede their judgment by requests for clarification of the Board's rules so they could be applied mechanically. Worse, the FASB's standards became the opponent in a game of hide-and-seek played jointly by corporate managers and their financial engineers from banks and audit firms [see [Sunder, 2011b](#); [Dye et al., 2015](#); [Glover, 2013](#); [Group of Thirty, 2016](#)]. As [Lowenstein \[2008\]](#) rightly points out, "The real problem is that the [oversight, in this case Moody's] agencies' mathematical formulas look backward while life is lived forward. That is unlikely to change." The intended solutions often turned into a problem. In the aftermath of Enron and related controversies, the criticism that the FASB was developing rules rather than principles-based accounting appeared after three decades of hard work by the Board. What is worse, this criticism came across the Atlantic from those who would have liked nothing better than to have matched the thickness and the detail of FASB's rulebook if only they had had the time and resources to do so.<sup>2</sup>

The task of a standard-setting body is difficult. Even if it knew the criteria for desirable rules, it would be difficult for it to know which rule(s) best fulfill the chosen criteria. The advice it receives is largely self-serving. Reliable forecasts of the consequences of alternative rules, especially the newly minted ones, are almost impossible to get. Comparative studies from the field require competition among alternative rules. A global monopoly of a single set of standards will make it virtually impossible to gather data from the field to support informed

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<sup>2</sup>The International Accounting Standards Board (IASB), with over 100 member countries, is the biggest and the most consequential adoption of the idea that accounting should be guided by rules framed by a deliberative body, instead of principles that may evolve through practice and their general acceptance. IASB's insistence on being "principles-based" appears silly when one searches in vain for other learned professions whose principles take over 3,000 pages to articulate.

choices after considering the consequences of alternatives. Poorly chosen rules will persist because any challenges to the choices made by a monopoly rule-maker will become so much more difficult to support by data in a world without alternative practices.

The standards approach to accounting has the advantage of speedy action in response to changing conditions combined with the disadvantage of the risk that the action makes things worse, not better. A standard-setting body can be likened to a fire brigade, standing ready to deploy its expert resources to address any perceived abuses in financial reporting and come up with a rule to block it in the future. It is not an effective instrument for anticipating how the targets of such blocking actions will react, and whether the ultimate outcome of their behavior after they have adjusted to the new rules will be more or less desirable than the status quo. Many well-intentioned accounting standard-setting projects have foundered on the rocks of this action-reaction sequence between rules and managerial behavior.

Recognizing the economics of this game, managers, investment bankers, and lawyers play with accounting rules, presenting a dilemma to the rule-makers. The rule-makers can analyze the likely consequences of the game by assigning motives to the players. For example, the managers may be assumed to maximize the present value of their personal compensation over their careers, and the investment bankers may be assumed to maximize the present value of their fees from transactions. While perfectly understandable in private domains, such analyses are difficult to reconcile in public with the pretense of professionalism. The rule-makers cannot question such private motives of their constituents without having their own personal motives subjected to similar scrutiny. Instead of washing all this dirty linen in public, both the rule-makers as well as their constituents engage in a ritual dance of nuanced language and actions where everyone pretends that everyone is working in the best interests of the public — especially the investing public — and avoid serious analysis of the real motives, alternative options, and implicit threats of the players in the game.

The existence of a permanent standard-setting establishment weakens the auditors' ability and willingness to use their judgment. Under pressure from clients, they petition the rule-maker for "clarifications"

of the rules already on the books. There is no rational basis for the rule-maker to select some of these requests over others for compliance. Sooner or later the number of such requests that end up on the agenda is limited only by the budget and schedule of the rule-makers. After all, the rule-making organization itself needs items for its agenda in order to remain in business, and has limited resources. A permanent establishment and progressive “clarification” of the rules reinforce each other. The rulebook grows thicker; and the question of whether the financial reports that result from such rules fairly represent the status and performance of the organization gets buried deeper under the procedural thicket. Even if the auditor or the manager doubts the fairness of a financial report, s/he would have to choose between the letter of the concrete rules — which s/he is required to follow under the threat of sanctions, and their spirit — which is a matter of judgment and vaguely specified consequences. It is hardly surprising that the auditor prefers the letter to the spirit of the rules.

After Enron and other financial reporting scandals, there has been much discussion about rule- versus principles-based accounting. A permanent body for writing accounting standards, which will stick to the principles without getting into the detailed rules, is an oxymoron. Setting up rule-making committees and boards is the easy thing to do. Many countries followed the US lead in doing so. In a democratic system of government it is awkward to argue against the rule of law in accounting, backed by enforcement authority.

The concept of common law developed in England through custom, acceptance and judicial precedent. According to [Landry](#),

“Common law is law that comes from the common people, vers. Legislation, which, comes from the “experts.” “. . . their Authoritative and Original Institutions are not set down in Writing in that Manner, or with that Authority that Acts of Parliament are, but they are grown into Use, and have acquired their binding Power and the Force of Laws by a long and immemorial Usage, and by the Strength of Custom and Reception in this Kingdom. The Matters indeed, and the Substance of those Laws, are in Writing, but the formal



and obliging Force and Power of them grows by long Custom and Use, as will fully appear in the ensuing Discourse.” They are available “. . . for the most part extant in Records of Pleas, Proceedings and Judgments, in Books of Reports, and Judicial Decisions, in Tractates of Learned Men’s Arguments and Opinions, preserved from ancient Times, and still extant in Writing.” [Hale \[1713\]](#).

It is useful to reconsider the merits of the common law approach after the results we have obtained in recent decades. While the common law approach is not acceptable *in toto*, we may consider allowing at least a few alternative sets of accounting standards to compete within each jurisdiction.

## 6.4 Auditing

The Securities Exchange Act of 1934 required publicly held corporations to have independent outside auditors certify the fairness of their financial reports. Though an early draft of the legislation assigned this duty to the General Accounting Office (GAO, an oversight branch of the US Congress), Col. Arthur H. Carter of the New York State Society of Certified Public Accountants persuaded Congress to give the audit franchise to CPAs. Mandatory audit by CPAs has remained the practice for eight decades. Both components of this audit institution — the mandatory requirement, as well as the exclusive franchise to conduct such audits granted to the members of a private organization — deserve scrutiny.

### 6.4.1 Mandatory audit

Publicly held corporations often employed independent audits long before the 1933 law made them mandatory for them. It is understandable that audits conducted by independent outside auditors help inform the investors about the integrity of the certified corporate reports. The imposition of such a legal requirement in the aftermath of the business scandals of the late nineteen twenties, and the stock market crash of 1929 may have helped restore investor confidence. Whether such a

requirement imposed on a permanent basis creates a better-informed market is less obvious.

In the pre-1933 regime, directors and managers of each firm decided whether to undertake an independent audit with its attendant costs, effort, and the potential modification of the financial reports, even with the possibility of embarrassment if the auditors discovered errors or malfeasance. They had to weigh these negatives to the firm and to themselves against the potential benefits of convincing its shareholders, lenders and tax collectors of the reliability of the financial reports. When these benefits exceeded the costs, the firm would undertake the independent audit. If the cost or risk of the audit was not worth the benefits of higher investor confidence, they would have dispensed with the audit unless it was demanded by some other regulatory process such as rate-setting for utilities.

This cross-sectional variation in whether or not a firm subjects itself to an independent audit is valuable information to the investors. All things being equal, the investors can logically conclude that the firms that choose to have their financial reports audited by independent auditors have nothing to hide from the investors; that the managers of such firms are relatively more confident about the status, performance and prospects of their business; and that they deserve the trust of the investors. On the other hand, the investors may logically conclude that the firms which choose not to have their financial reports audited by independent auditors, even though they could have done so, are less deserving of the investors' trust and funds.

Making independent audit a statutory requirement shuts the door on the ability of better managers to distinguish themselves from their less competent brethren in the eyes of investors. The decision to engage an outside auditor is a costly signal that only the better managers will find worth paying for. For the less competent managers, the cost of the independent audit is not worth the benefit; their fear of exposure would keep them from subjecting themselves to an independent audit. In the pre-1933 era, the better-run firms could signal their status to the investors by engaging outside auditors; the other firms could not afford to issue such false signals because they were costly. The statutory requirement to have all publicly held firms engage such auditors

eliminated the signal, and in this sense, reduced the amount of information available to the investors about the firms and their managers. The economic consequences of a well-intentioned change in the law can be at surprising variance with the underlying legislative intent.

#### 6.4.2 Independence of auditors

The independence of auditors has been the subject of extensive comment and analysis. Recent debates have focused on the infringement of independence by fees for consulting services rendered by the firms to their audit clients. Charges of such infringement are credible, despite denials by the audit industry. In the United States, the audit industry temporarily scaled back on marketing consulting services to its audit clients in the wake of Sarbanes–Oxley legislation.

However, the independence problem is deeper than consulting. If the consulting revenues encroach upon the independence of the auditors, so must the revenues from the audit services. If the auditors' judgments are likely to be influenced in the direction favorable to management by the prospect of gaining consulting services, gaining or retaining the sale of audit services should also be expected to have a similar, if not stronger, effect on their judgments. Under the current system, managers whose representations are the subject of the audit, are also the paymasters of the auditors.

As mentioned previously, an early draft of the Securities Exchange Act named the GAO to conduct the audit of publicly held firms. A government monopoly on a statutory audit presents difficult managerial problems of promoting efficiency and improving the technology of auditing. Variations on this theme could include an audit by organizations controlled by stock exchanges in which the securities of the firm are listed, or states in which the firm is incorporated.<sup>3</sup> Such audits could remain mandatory, and become a part of the package of regulatory services on which the stock exchanges or the states compete with

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<sup>3</sup>Unlike most countries of the world, the United States allows corporations to be incorporated under the laws of any of the 50 states. This system of “competitive federalism” is referred to elsewhere in this note. See Romano (2002).

one another. Alternatively, the exchanges or the states could let the firms choose if they wish to be listed as an audited or as an unaudited corporation, and make their choice of audit status known to investors. The ability of firms to choose among the exchanges or the states, and between the audited and unaudited status will minimize the chances that their regulatory auditors will extract large rents from them; or that such auditors will be grossly inefficient, as might be the case with a single nationwide auditor controlled by the government.

### **6.5 Competition versus independence**

Although the recent debate on auditing has been focused largely on auditor independence, such was not always the case. In the 1970s, the US Congress subjected the audit industry to intense scrutiny for insufficient competition (see the US Congress reports of the Moss and the Metcalf committees, 1976). Competition and auditor independence are closely linked to each other in a complex relationship. Policies based on the insufficient appreciation of this link share the blame for the loss of both competition as well as independence in the audit industry.

Consider an almost mechanical linkage between audit independence and competition. At one extreme, we could have a single, very large, audit firm for the entire economy. This monopoly auditor would have enough resources to audit all firms. No single client would account for a sufficiently large proportion of its revenue. This auditor would be maximally independent, but the market for audit services would have no competition, generating potential inefficiencies associated with monopolies. At the other extreme, we could have a large number of small auditors. In such a maximally competitive market, independence will become scarce. Each auditor will be largely dependent on its small number of clients for his livelihood, and be more susceptible to client pressure. There are other possibilities between these two extremes. As we move from one end of the spectrum towards the other, we can gain more competition by sacrificing some independence, or gain more independence by sacrificing some competition. We cannot attain more of both.

## 6.6 Unintended consequences of pursuit of competition

Paradoxically, after a quarter-century long pursuit of competition by policy makers, the US audit industry has been reduced to only four major competitors. How did this come about? This takes us to the second level of analysis.

While the antitrust laws to promote competition in trade and industry have been on the books in the United States since the late nineteenth century, these laws were not enforced on “learned professionals” such as doctors, lawyers, and accountants. In their codes of ethics, the professional associations included provisions to proscribe advertising and solicitation of competitors’ clients and employees as being unprofessional. The economic rationale for this informal exemption for the professions lay in the asymmetry of information. It is difficult for the clients of the professionals to see the quality of services rendered to them. Indeed, they often rely on the professionals to advise them on what services they should buy. Emphasizing competition in this setting, it was feared, would result in lowering not only the price but also the quality of the professional services. George Akerlof, formalized this idea in his model of the “Market for ‘Lemons’” for which he received the Swedish Riksbank Prize in Economic Sciences in Memory of Alfred Nobel in 2001.

About the time Akerlof’s argument was published in 1970, questions were already being raised about its validity for the markets for professional services. Stigler argued that competition was a robust phenomenon, and that the reputation of the quality of goods or services provided served as an effective antidote for the problems caused by information asymmetries. When sellers can develop reputations with the customers, we need not fear that the competition will lower the quality of goods or services they sell.

The US Supreme Court, which had heretofore sustained the ban on advertising in the market for professional services, ruled in 1977 that the Bar of the State of Arizona could not prevent its members from advertising their services [Bates v. State Bar of Arizona, 1977]. Though the case was decided on the grounds of (commercial) free speech guaranteed by the First Amendment to the US Constitution, arguments

about the opportunity to build a reputation played an important role in this ruling. Though not directed at them, it turned out to be a watershed ruling for the auditing profession in the United States.

The Supreme Court ruling led the US government to change its policy on professional competition, and the latter forced the professional associations to drop the anticompetitive provisions from their codes of ethics. The American Institute of CPAs changed its Code of Ethics effective 1979, resulting in major, largely unanticipated, consequences.

Generalization of the reputation argument from the professions of medicine, dentistry, and law to auditing was fundamentally flawed because the results of the medical and legal services are observable, at least *ex post*, to the customers in a relatively prompt manner. Since such observations have a reasonable, albeit imperfect, correlation with the quality of services rendered, reputation can keep these markets from collapsing under competition. This is not the case with the market for audit services.

Corporate managers and directors hire the auditors. The real clients of the auditors — the investors — never see the auditors. Even if they did, they could not tell if the auditors did their job diligently. Managers who see the auditors hardly have an incentives to check on auditor's diligence in verifying managerial representations to investors and others. Only on rare occasions, when a corporation runs into serious financial distress, questions may arise about the fairness of its financial reports and the quality of the audit work behind their certification. More than 99% of the time, no questions are raised about the quality of the audit, and no one scrutinizes what the auditors actually did.<sup>4</sup> In this environment, there is hardly any opportunity for the auditors to build their reputation based on the quality of their work. Thus the reputation argument cannot be generalized from other professions to the auditing profession.

Yet it was generalized to accounting, and under the pressure of competition, auditing turned into a “market for lemons.” The prices dropped as the corporate controllers solicited new bids from audit firms,

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<sup>4</sup>After enactment of Sarbanes–Oxley Act in 2002, PCAOB does scrutinize a small sample of audits but, inexplicably, the bulk of the results of the scrutiny remain confidential and so do not serve their intended function.

year after year, to get their auditors to lower the fees. At these ever-declining prices, the auditors could not deliver quality service and still earn a decent living. Something had to change, and it did. To survive in this new competitive environment which had been forced upon them, auditors built themselves a new business model. It had three elements — a new product mix, a new production function, and a new compensation policy.

### **6.6.1 A new business model for audit firms**

A certain amount of business advisory or consulting services had long been a part of the product mix that auditors offered their clients. The auditors could make money by selling consulting services to their audit clients because they already had access and a working business relationship with the top echelons of management, and detailed knowledge of the operations, financial status, and strengths and weaknesses of the business. An established relationship of mutual trust made it easier for management to ask for advisory help from the consulting partners of their auditor, instead of searching elsewhere. Management saved the search costs, and the consultants working inside the audit firm saved a large fraction of their marketing costs. The auditors decided to exploit this cost advantage to sustain the audit operations in which it had become difficult to earn money. Unlike audit services, customers of consulting services are managers themselves, and they are able to observe and assess the quality of consulting services much better than the remote shareholders can assess the quality of audit services. In spite of auditors' cost advantage and competing providers, the consulting market did not become a market for lemons.

Auditing failures are often blamed on the provision of consulting services to audit client. Admittedly, the rapid expansion of consulting services peddled to the audit clients could not have had a salutary effect on the diligence with which auditors examined the fairness of the financial reports. However, the expansion of the consulting services to become the tail that wagged the dog of the auditing business came about as a consequence of the collapse of the profitability of audit services: as the government pushed competition on the audit business,

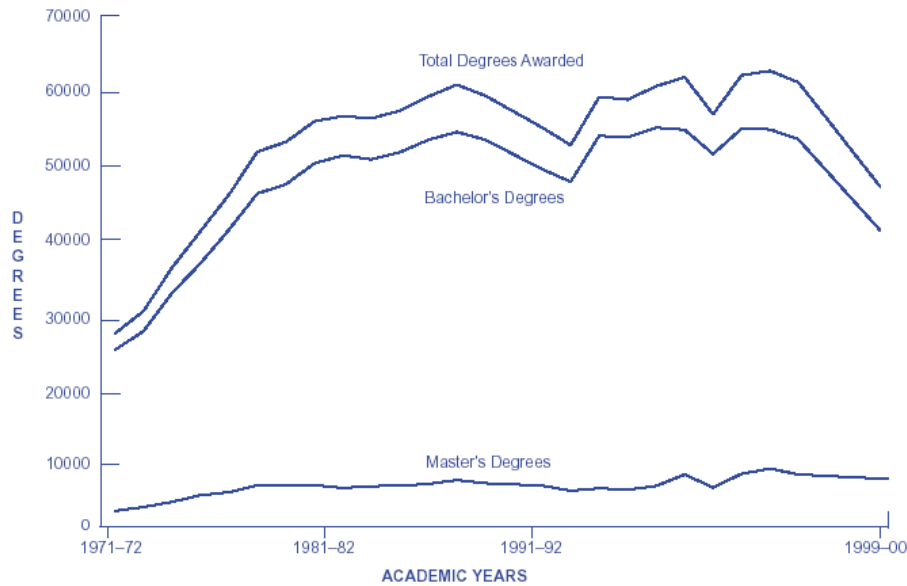
and the audit prices and profitability collapsed, the auditors turned to consulting as a recourse. Thus the expansion of consulting was a consequence — not the cause — of the collapse of the audit market. Unfortunately, solutions such as the SOX legislation, that purportedly deals with the collapse of auditing, have misdiagnosed the symptom of consulting to be the cause and are unlikely to be effective.

The second element of the business model was a new production function for auditing. Audit work consists of two main elements — analytical review and substantive testing. Analytical review is a structural, temporal, and cross-sectional comparative evaluation of the financial report to assess its overall soundness. Once the auditor has invested the effort to model the firm and its environment, analytical review comes easy. Substantive testing is the direct verification of the resources and obligations of the firm in the field, and requires the costly checking of physical plant, inventories, creditors, and debtors of the firm. Although the auditors developed sophisticated statistical techniques to design efficient sampling methods to cut these costs during the third quarter of the twentieth century, substantive testing consumed the bulk of the auditing budgets. Under the pressure of competition, the auditors shifted their production function from expensive substantive testing towards inexpensive analytical reviews. A greater part of the audit work could now be carried out without leaving the office, with less time, labor, and cost.

The third element of the new business model was to lower the compensation of the new entrants to the audit profession. This was reflected almost immediately in the drop in the number of college students choosing to major in accounting, and a few years later, in the number of US undergraduate accounting majors and candidates for the CPA examination (see Figures 6.1 and 6.2 from AICPA 2002).

Auditors might have hoped that this new business model would sustain the economic viability of their firms. But it could not, because the shift in the business model had important consequences that the model had not accounted for. The cut backs in substantive testing — the auditors visiting the warehouse shelves to count inventories and requesting direct confirmations from debtors of their clients — meant more opportunities for willing managers to misrepresent their numbers, with a



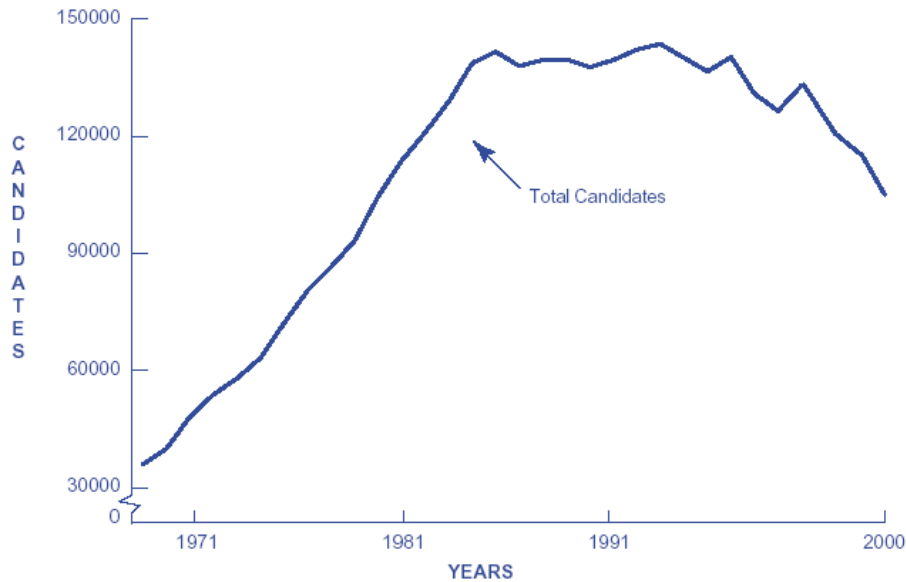


**Figure 6.1:** Undergraduate accounting degrees awarded in the United States.  
*Source:* AICPA [2002].

lower chance of being discovered. Increased emphasis on selling high margin consulting services to their audit clients forced even haughty audit partners to become pleading salesmen at the clients' door. Such partners were hardly in a position to stick to their judgments about the fairness of the financial reports in high stakes negotiations with the chief executive and financial officers of the firms; the latter could always throw another consulting project their way, and hint at finding another auditor. The drop in audit prices forced a change in the production function and the product mix, which in turn cut into the quality of audit services. But the auditors' liability had not been scaled back. The consequences followed none too soon.

### 6.6.2 Liabilities eat the profits

By the mid-1980s auditors saw a sharp rise in the number of lawsuits against them alleging negligence. The suits worked their way through



**Figure 6.2:** Candidates of CPA examination in the United States.  
*Source:* AICPA [2002].

the in- or out-of-court settlements, including some cases where auditors paid over a 100 million dollars in damages for a single audit. The new business model did not yield the hoped for profits, and the auditors had to revise it again. They reinforced all three elements mentioned earlier, and added a fourth. Consulting services had already become the mainstay of audit firm profitability. They shifted their college recruiting to people who could work on consulting, not auditing projects. Abandoning their long-held policy of pushing the universities to offer courses in advanced accounting skills that could be employed in audit tasks, the major accounting firms financed the Accounting Education Change Commission for the American Accounting Association, urging the universities to train strategic thinkers (read consultants) instead of accountants. They continued to move the audit production function away from substantive tests to analytical models to reduce the labor costs of audit. The profession was determined to follow its new business model to deal with the consequences of the competition that had been

forced upon it. The auditors' liability stood in the way and they turned their attention to it.

When the courts found that the audited financial reports did not fairly represent the financial status and performance of the firm, the auditors were held jointly and severally liable, along with managers, directors, etc., and asked to pay damages to the plaintiffs. Far too often in such cases, the other parties held liable had little resources, and the auditors ended up paying the share of damages attributable to themselves as well as to the others. The auditors identified this joint-and-several liability doctrine as the main source of their problems, and determined to get it replaced by proportional liability which would allow them to pay only their own share of the damages. How was this change to be accomplished?

### **6.6.3 A political strategy**

Physicians and lawyers had financed elections for many years, and benefited handsomely from the political payoffs from their benefactors. Accountants, too, decided to follow suit, and began to organize and raise money to finance elections in order to gain access to legislators. They ramped up financial contributions to the elections in 1988, 1990, 1992, and 1994 and lobbying efforts in Washington and the state legislatures. In 1995, Congress finally passed the Private Securities Litigation Reform Act, switching the auditors' liability from joint and several to proportional. As a sweetener to the business lobby from the US high-tech industry, this Act also permitted publicly held companies to include forward looking statements in their financial reports under a safe harbor provision. As long as such statements were clearly labeled to be forward looking, the management could not be held liable for any errors. It was a measure of the lobbying power of the accountants that this was the only Act passed by Congress overturning a veto during the eight years of Bill Clinton's presidency.

The 1995 Act cleared the way for the auditor's new business model to take effect. They no longer wished to be called mere auditors or accountants. The new production function cut back on audit effort anyway. A new term — assurance services — was coined for the audit part of their business. With the revenues from consulting they thought

they could pay their share of proportional liabilities arising from the assurance services. At Arthur Andersen & Company, the authority to make the final call on matters of accounting principles was transferred from their legendary and tough central office group in Chicago to the engagement partners who were directly responsible for the audit in the field. The pressures on audit partners to fulfill their quota of consulting revenues from their audit clients rose to a level that forced many old-timers to quit by taking early retirement. The rush for making money in the go-go days of the dotcom bubble was on, and the auditors became the perpetrators, the short-term beneficiaries, and ultimately the victims of the bubble.

#### **6.6.4 SEC fumbles diagnosis**

The SEC saw the disaster looming and tried to stop this race, but like many others, misdiagnosed the consulting revenues of the audit firms as the source of the problem. It did not see that the growth of consulting for audit clients was a consequence of the competition that had been pushed on auditing through the change in government policy in the 1970s. In any case, the accountants used their political muscle to partially beat back the SEC proposal to prohibit the audit firms from providing consulting services to their audit clients, and settled for public disclosure of the consulting fees.

All major economic and stock market downturns leave behind the detritus of collapsed businesses and dashed hopes, including some accounting and auditing scandals. The events of 2002 were different only in the unusually large number of accounting and auditing related surprises, and their large magnitude, often running into billions of dollars. It did not help that in pushing competition on all professions in the late seventies, the government policy failed to consider the special susceptibility of the market for audit services to become a “market for lemons.” In pushing for competition, the government not only damaged auditor independence, but competition too. After a quarter-century of efforts to promote competition, the number of large audit firms that audited most publicly held firms was halved to four.

## **6.7 Summary**

Designing social institutions to achieve specific goals is not easy to do. As the preceding discussion suggests, we can use what little we know and implement new designs with an understanding that it will be a trial-and-error process at best, with little assurance of success. Since accounting regulators have not succeeded in getting any significant number of leases capitalized after about 55 attempts in over six decades, we should not engage in this endeavor with high hopes. An alternative is to let the system evolve more slowly through incremental changes of a bottom-up process. However, when financial reporting abuses are noticed, it is difficult not to rush to make new rules because our confidence exceeds our abilities.

Separation of accounting for taxation and financial reporting in the United States is a good example of this over-confidence in our ability to optimize them both separately. It is possible that if they were not allowed to diverge, their co-evolution will discipline both through their divergent incentives on business organizations. Such conformity will significantly simplify the tax code and financial reporting rules, and save a significant bundle in tax and financial audit costs — a dead weight loss to society.

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## Ways Forward

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A great deal of accounting scholarship has addressed the micro-level details of relationships among rules, reports, disclosures, and individual decisions and market behavior. This work has yielded many insights into financial reporting viewed as a source of information for individual decision making, and as a multi-person game in which participants seek their own goals. Putting social norms as well as game theory on the back burner, accounting institutions have been created to serve the purported goal of decision making under the label of “decision-usefulness;” extensive written standards of financial reporting and auditing are the most visible outcomes of this endeavor.

Stepping back to take a broader perspective on the evolution of accounting and auditing over the past century raises a different question: Is financial reporting better now than in the past? It is difficult to answer this question, and this question prompts an even more challenging hypothetical question: Would financial reporting have been better had the recent decades’ regulatory attempts to improve it not been undertaken?

Section 2 suggests that “better reporting” is not meaningful if we look at the world through Panglossian glasses of positive theory in

which accounting, like weddings and other rituals of life, simply is what it is. Research on better reporting is no more fruitful than research on making weddings better. One might wonder why so much research is being done on financial reporting since positive theory has become the dominant paradigm. Perhaps research too, viewed through Panglossian glasses, simply is what it is, not susceptible to value judgments about its purpose, direction, quality, or achievement.

As a matter of personal perspective, I think of financial reporting not simply as a social phenomenon but also as a human artifact engineered to serve human purposes. Section 2 explored attributes and objectives approaches to seek guidance for our actions. The appeal of both of these approaches is coupled with the implausibility of either of them yielding rationally defensible choices. Multiple desirable attributes of financial reporting are largely incommensurate, and multiple goals of society and of various groups are irreconcilable at all but the most general, almost philosophical, levels. The analytical approach to progress towards better financial reporting is consequently blocked.

Sections 4–6 explore rules, social norms, and institutions. The appeal of written rules — concrete, salient, published, easily disseminated, catalogued, and specified with precision, subject to analysis and discussion, formulated by known transparent and often democratic processes, subjected to comments and amendments and enforcement by socially accepted processes, is obvious. Written rules appeal to our sense of good housekeeping. Social norms, on the other hand, are messy, vaguely defined, variable in time and space, calling for extended socialization to learn and internalize, with a penumbra of uncertainty, evolved slowly by poorly understood processes, difficult to direct at identifiable problems of the day, are almost impossible to defend when scandals hit the news cycle, and mock our expertise and efficiency. Politicians find it so much easier to pacify the public by exercising their legislative powers to write new rules to ban the offending practices, devising administrative mechanisms for their enforcement, discrediting the prevailing norms, claiming victory, and moving on to the next month's headlines. But the problems reappear.

It is my hope that some configuration of rules, norms, and institutions may help us find a way out. We do need written rules; the cost

and time needed to coordinate, resolve conflicts, and maintain order by mutual understandings and expectations alone, beyond small family groups, are unbearably large. The Code of Hammurabi spelled out 282 laws for everyone in his kingdom for this purpose some four millennia ago.

It is not possible to write rules for every known contingency. The relationship between written details and their effectiveness in achieving the intended consequences is unclear. Loopholes unshakably shadow every rule; attempts to close the loopholes by adding detail only opens new ones. One's social life is rendered possible only by the system of less formal shared mutual expectations of behavior and largely internalized sanctions we call social and cultural norms. Rules and norms work in tandem like the stereotypical father's discipline and the mother's softer warmth to raise a healthy and happy child.

The adoption of International Financial Reporting Standards (IFRS) in the European Union and some other countries was promoted by aspirational rhetoric about gains from uniformity. Since outcomes are determined jointly by the rules, and the environment to which they are applied, application of the same process or rule to diverse societies does not yield comparable outcomes. We need to assess not only if the vision of one set of global accounting standards is achievable but also if it is desirable. See [Catanach and Ketz \[2011\]](#) for some negative consequences and [Sunder \[2007, 2009\]](#) and [Fearnley and Sunder \[2012\]](#) on other questionable aspects of IFRS.

The practice of financial reporting interacts in complex ways with the prevailing law, commercial code, economic environment, and business practices. The complexity and interactivity of social systems and markets makes it difficult for a group of experts to devise accounting solutions to better serve even a simple, much less diverse, economy. Even if it were feasible, solutions could only be developed through bottom-up evolution of accounting and not through top-down imposition of a single method selected by a board of "experts" with limited accountability and without field trials of their new formulations. [Waymire and Basu \[2007\]](#) argue that accounting is an evolved institution.



There are no recipes for effectively combining the rules and norms. Perhaps our hope lies in building and supporting institutions to attain an acceptable balance between the two. Since human intelligence is not proficient in designing social systems top-down, a good dose of modesty in proposing such institutions is called for. What might such institutions look like? Let me conclude with a rough outline.

The institutions of accounting should have a broad representation from the relevant constituencies, and not be dominated by specialized interest groups. Such institutions will take into account the consequences of their actions for various parts of society.

These institutions should try to develop a consensus, and not act by mere majority vote. It will allow some parties to block issuance of rules when they are not yet ready to be accepted broadly by the business and accounting community. This will also mean that such institutions will not be biased towards action, nor will they be assessed by the rate at which they issue new pronouncements. It is entirely possible that such organizations may issue fewer pronouncements, and may not issue any pronouncements during significant intervals of time. When that happens, it will be an indication of their care in serving their diverse community, and not of incompetence.

Such institutions of accounting will rely on their power of reason, explanation, education, disclosure of practices, and development of consensus, instead of the stick of regulatory enforcement. Their power to persuade will be more like that of the Oxford English Dictionary, which allows for the slow evolution of the meaning of words, adding new words from current usage, but also serving as a book of reference and an informal disciplinary and dispute resolution mechanism. Such institutions do not shy away from diversity. On the contrary, diversity of practice serves as the feedstock of innovation, deliberation, comparative research, learning, and new ideas.

Before proposing untried new ideas for adoption in practice, such institutions will conduct field tests of their own. They can do so by encouraging some organizations to implement the proposals on a trial basis in their financial reports, as well as by beta testing them with the

general public, especially the students, to find the weaknesses in the proposals.

The institutional structure will be more resilient, especially in a world of financial engineering,<sup>1</sup> if it resists the temptations of monopoly. To the extent a handful of institutions are permitted to compete for allegiance of, and revenues from, the same reporting entities and their constituents, under broad soft-touch regulatory supervision, they will compare, learn, innovate, and balance various interests more effectively. Since fees from firms who choose to comply with their standards will be the sole source of their revenue, rule makers will have to balance the interests of not only the preparers but also the users and auditors while earning for their own economic survival.<sup>2</sup> It will also be easier for competing institutions to resist the pressures to write increasingly detailed rules if users do not pay attention to financial reports prepared from such rules [Sunder, 2011b]. It would be possible, for example, for a competing audit regime to operate without mandatory audit, and for a financial reporting regime to require full conformity with tax reporting. Whether any entities choose to operate under such regimes without being abandoned by their investors and other constituents will not be known until the doors of competition are opened. Extensive consumer surveys of Coca Cola Co. to compare consumer tastes for old and new Coke — a simple product compared to reporting rules — came to naught when the new version bombed in the market place [Schindler, 1992].

Such “soft” institutions could be back-stopped by newly created accounting courts to decide on, and develop a body of case law of financial reporting. These courts will judge the cases before them by common law criteria such as “true and fair” representation, and not by conformity to published rules alone.

Even robust institutions break down under sufficient pressure. The self-interest of constituents is the incessant source of such pressures on

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<sup>1</sup>See Dye et al. [2015] and Abdel-Khalik [2016] for examples. Tavakoli [2008] is a good reference.

<sup>2</sup>Note that the FASB and IASB do not compete, either for allegiance or revenues. They enjoy virtual monopolies in their respective jurisdictions, and for a while collaborated to achieve “convergence.”

financial reporting. During the recent decades, such pressures on financial reporting often rose from performance-contingent executive compensation. When millions or hundreds of millions of dollars of executive compensation is tied to income and sales in financial reports, maintaining the integrity of the reports becomes difficult. US regulators have not helped by their mixed record in this respect. On the one hand, they have tried to reign in excessive compensation of senior executives by highlighting the ratio of senior executive and median employee compensation [McGrane and Lublin, 2015]. On the other hand, they have asked public companies to link executive compensation to measured financial performance [SEC, 2015]. Promoting such linkage will only increase the pressure on financial reports and undermine softer approach to institutions of accounting.

We cannot be sure if these suggestions will result in better financial reporting. Since the measures of the quality of financial reports remain vague at best, there is little agreement on how to look for evidence on whether we have made progress in that direction during the past eight decades. Perhaps it would not hurt to try these ideas, or at least engage in active debate on alternatives to the status quo.

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