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Rethinking Financial Reporting: Standards, Norms and Institutions

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An Overview

- Passage of the US federal securities laws in 1933-34: growth of accounting rules from six short paragraphs in 1935 to over 10,000 pages now
- Much regulatory effort devoted to improving financial reporting in business, government and not-for-profit organizations
- Reports are longer (sometimes more than 500 pages), but other evidence on improvements or abatement of misreporting by error or intent remains unclear
- Some agreement may help us make progress:
  - What is better financial reporting?
  - How could we move in that direction?
- Multiple perspectives on *better financial reporting:* examples
  - **Descriptive**: based on identifiable properties of accounting systems or their output (e.g., double-entry, true-and-fair, qualitative, independence)
  - **Functional:** based on purposes accounting may serve (e.g., operations, markets, public finances, macro-economic management, tax collection, provision of information)
  - **Procedural**: based on procedures used (e.g., computerized, continuously audited, regulatory)
- Conflicting elements point to the political aspects of collective choice; not unique to financial reporting

An Overview (Contd.)

- Alternative approach: shift focus from specific rules to process and institutions
  - Create and sustain 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
- Institutional/process emphasis departs from the tendency to interject radical new rules, disregarding the lessons of practice
  - New rules as a problem; creating confusion and failures in financial reporting and regulation over the past century
- Eagerness to deal with transaction innovations through new rules fuels the cycle of more innovations, misrepresentations and abuse
  - Accountants are guaranteed losers in the arms race with financial engineers
- Excessive emphasis on written rules accompanied by waning professional responsibility for good judgment, regard for practice and practicality, and public interest
- Perhaps some balanced combination of
  - Regulation and compliance regime
  - Tradition and emergent social norms
  - Market competition and innovation, constraining rule-making activist institutions
- If so, how do we develop such institutions?
- Need greater diversity of perspectives

A Basic Problem of Financial Reporting

- Reflexivity between transactions and how they are represented in financial reports
  - Representation of transactions and the transactions themselves are mutually adjusted
  - If seen as a game between preparers and regulators of financial reports, stable solutions are difficult to find
  - Stable solutions may not have "satisfactory" properties
- An illustration: lease transactions

Car Rental vs. 25-Year Aircraft Lease

- Car Rental
  - Two days
  - Service delivered and paid for
  - Rent expense deducted from income
  - No entry made in balance sheet

Airline Needs an Aircraft for 25-Years

Borrow money to buy

- Borrow money from a bank
- Pay the money to manufacturer to buy the aircraft
- Pay interest to the bank (expense)
- Depreciate the cost of aircraft over its expected life of 25 years (expense)
- Make payments to amortize the loan
- Undepreciated cost of aircraft appears as asset on balance sheet
- Unamortized PV of the loan appears as a long term liability (debt) on balance sheet
- The transaction raises the debt/equity ratio (leverage) of the airline

Lease

- Bank buys the aircraft (or airline buys, sells to bank)
- Bank leases it to the airline for its expected life of 25 years (non-cancellable)
- Airline pays annual (or monthly) lease rentals to the bank
- No entries made in balance sheet for aircraft asset or the future obligation to pay rent to the bank
- Airline's debt/equity ratio (and its presumed capacity to borrow additional funds) remains unchanged

Numerical Example

Borrow money to buy

- Change in Income = Interest - 100 (10% of 1,000)- Depreciation 40
- Change in assets = +1,000
- Change in liabilities = +1,000
- Change in debt/Equity ratio = $(D_1+1{,}000)/(OE_1 + D_1 + 1{,}000)$
- The D/E ratio rises

Lease

- Change in Income = Annual lease rental
- No change in assets
- No change in liabilities
- No change in D/E ratio

How Big Is This?

Ticker	Name	Operating Leases (in $mm)	% of Total Assets	Stock Rating
Most Off-Balance Sheet Debt				
WAG	Walgreen Company	$25,099	75%	3 Stars
CVS	CVS Caremark	$20,147	31%	3 Stars
T	AT&T	$19,323	7%	4 Stars
BAC	Bank of America	$14,037	1%	2 Stars
WMT	Wal-Mart	$12,570	6%	4 Stars
Most Off-Balance Sheet Debt as a % of total assets				
FVE	Five Star Quality Care	$1,222	214%	2 Stars
CMG	Chipotle Mexican Grill	$1,720	103%	3 Stars
RGC	Regal Entertainment Group	$2,226	101%	3 Stars
ANN	ANN Inc.	$805	91%	3 Stars
ARO	Aeropostale	$634	86%	3 Stars

Sources: New Constructs, LLC and company filings

More Examples of Off-Balance Sheet Debt?

- US Government (est.): $70 trillion
- UBS: CHF 60 billion in 2008

Attempts to Deal with this “Arbitrariness” in Financial Reports

- What is a lease? An arrangement contains a lease only when such arrangement conveys the right to “control” the use of an “identified asset.”
- Lease classification: removed bright lines without removing them.

Lease Accounting Rules: 43 Attempts in 67 Years

- Accounting Research Bulletin 38 (1949): reveal long term lease payments
- Accounting Research Study 4
- APB Opinions 5, 7, 27, 31
- SEC Accounting Series Releases 132, 141, 147
- FASB Standard 13 in 1976: 4 bright line criteria
- Intentions vs. consequences
- Redesign and a flood of responses
  - 25 more in six years, 43 in 37 yrs.
  - Most recently: ASC 842/IFRS 16 in 2016

Lease Accounting Rules:

Year	Author	Doc	Title
1949	AICPA-CAP	ARB 38	Disclosure of Long-Term Leases in Financial Statements of Lessees
1962	AICPA	ARS 4	Reporting of Leases in Financial Statements
1964	APB	APB Opinion 5	Reporting of Leases in Financial Statements of Lessees
1966	APB	APB Opinion 7	Accounting for Leases in Financial statements of Lessors
1972	APB	APB Opinion 27	Accounting for Lease Transactions by Manufacturer or Dealer Lessors
1973	SEC	ASR 132	Reporting of Leases in Financial Statements of Lessees
1973	SEC	ASR 141	Interpretations and Minor Amendments Applicable to Certain Revisions of Regulation S-X
1973	APB	APB Opinion 31	Disclosure of Lease Commitments by Lessees
1973	SEC	ASR 147	Notice of Adoption of Amendments to Regulation S-X Requiring Improved Disclosure of Leases
1974	FASB	DM	An Analysis of Issues Related to Accounting for Leases
1975	FASB	ED	Accounting for Leases

1977	FASB	FASB Interpretation 19	Lessee Guarantee of the Residual Value of Leased Property
1978	FASB	FASB Interpretation 21	Accounting for Leases in a Business Combination
1978	FASB	FAS 22	Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt
1978	FASB	FAS 23	Inception of the Lease
1978	FASB	FASB Interpretation 23	Leases of Certain Property Owned by a Government Unit or Authority
1978	FASB	FASB Interpretation 24	Leases Involving only a Part of a Building
1978	FASB	FASB Interpretation 26	Accounting for Purchase of a Leased Asset by the Lessee During the Term of the Lease
1978	FASB	FASB Interpretation 27	Accounting for a Loss on a Sublease
1979	FASB	FAS 26	Profit Recognition on Sales-Type Leases of Real Estate
1979	FASB	FAS 27	Classification of Renewals of Extensions of Existing Sales-Type or Direct Financing Leases
1979	FASB	FAS 28	Accounting for Sales with Leasebacks
1979	FASB	FAS 29	Determining Contingent Rentals
1979	FASB	Technical Bulletin 79-10	Fiscal Funding Clauses in Lease Agreements
1979	FASB	Technical Bulletin 79-11	Effects of a Penalty on the Terms of Lease
1979	FASB	Technical Bulletin 79-12	Interest Rate Used in Calculating the Present Value of Minimum Lease Payments
1979	FASB	Technical Bulletin 79-13	Applicability of FAS 13 to Current Value Financial Statements
1979	FASB	Technical Bulletin 79-14	Upward Adjustment of Guaranteed Residual Values
1979	FASB	Technical Bulletin 79-15	Accounting for Loss on a Sublease not Involving the Disposal of a Segment
1979	FASB	Technical Bulletin 79-16	Effect of a Reduction in Income Tax Rate on the Accounting for Leveraged Leases
1979		Technical Bulletin 79-17	Reporting Cumulative Effec t Adjustment from Retroactive Application of FAS 13
1979	FASB	Technical Bulletin 79-18	Transition Requirement of Certain FASB Amendments and Interpretations of FAS 13
1980	FASB	Technical Bulletin 79-16 (Revised)	Effect of a Change in Income Tax Rate on the Accounting for Leveraged Leases
1980	IASC	ED (E19)	Accounting for Leases
1982	IASC	IAS 17	Accounting for Leases

1982	IASC	IAS 17	Accounting for Leases
1996	G4+1	Special Report	Accounting for Leases: A New Approach
1997	IASC	ED (E56)	Leases
1997	IASC	IAS 17 (revised)	Leases
1999	G4+1	Special Report	Leases: Implementation of a New Approach
2003	IASB	IAS 17 (revised)	Leases
2005	FASB/IASB	Proposed FSP FAS 13-a	Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction
2009	FASB/IASB	Discussion Paper	Leases: Preliminary Views
2010	FASB/IASB	Proposed Standards Update	Proposed Accounting Standards Update—Leases (Topic 840)
2016	FASB/IASB	ASC 842/IFRS 16	Show all leases on the balance sheet; removed bright-line criteria (but not really)

Why Has It Been So Difficult?

- Attempts to deal with financial reporting as a rule-making problem
- Rules as replacement for judgment, professional and moral responsibility
- Shift in analysis of professions from sociology to economics (Friedman)

Perspectives on Accounting

- Descriptive: based on identifiable properties of accounting systems or their output
- Functional: based on purposes it may serve
- Procedural: based on procedures used
- Possibly others

Descriptive Perspectives

Based on identifiable properties of accounting systems or their output

- Double-entry
- True-and-fair
- Qualitative data
- Verifiable
- Reliable
- Historical
- Market-based
- A given accounting system may not meet all descriptive perspectives simultaneously

Functional Perspectives

(Based on the purposes it may serve)

- Facilitating efficient operations (factory, office, receivable, inventory, taxation, etc.)
- Helping maintain "better" markets (financial)
- Better management of public finances
- Better macro-economic management
- Provision of information to relevant economic agents

Procedural Perspectives

(Based on procedures used)

- Computerized
- Continuously audited
- Regulatory compliance
- Tradition and ritual

What is Better Financial Reporting?

- Calls for "…high quality standards…" without specifying what it means (in a discipline devoted to measurement!) do not help
- Can quality of financial reports be assessed in some agreed upon fashion? And,
- Does issuance of written standards/rules help improve reporting?
- Are the answers to these questions an affirmative "yes"?

Six Approaches to Meanings

- Three based on attributes of financial reports
  - Pursuit of truth
  - Qualitative attributes
  - Measurable statistical or descriptive properties of the contents
- Two based on goals
  - Serving some broad societal goals
  - Serving the goals of some specific individual(s) or group(s)
- One as a social practice (ritual or tradition)
  - Not rationalizable as a validated means to achieve some specific attributes or goals (e.g., rain dance, commencement, faculty meetings)

Attribute-based Approaches: True-and-Fair

- Laymen’s question about financial reports: Why can’t the accountants just tell the simple truth?
- But, there are many truths
- What is true may not be simple; what is simple may not be true
- Historical cost and Mark-to-market have their own respective claims on meet the *true-and-fair* criterion
- This attribute does not guide us about how to make trade-offs
- But it retains its appeal as an aspirational criterion, like the honor codes of many universities
- The U.S. Declaration of Independence is based on men’s inalienable right to “life, liberty and pursuit of happiness”; but not codified in law

Meanings: Qualitative Attributes

- faithful representation
- Timeliness
- Relevance
- Reliability
- Verifiability
- Uniformity
- Consistency
- Comparability
- Cost-benefit efficiency
- Conservatism
- Robustness to manipulation and fraud
- Governmental organizations: transparency, public accountability, and citizen empowerment and engagement with the organization

Meanings: Attributes

"Everything's a tradeoff — now that I can walk upright, I can't wiggle my ears any more."

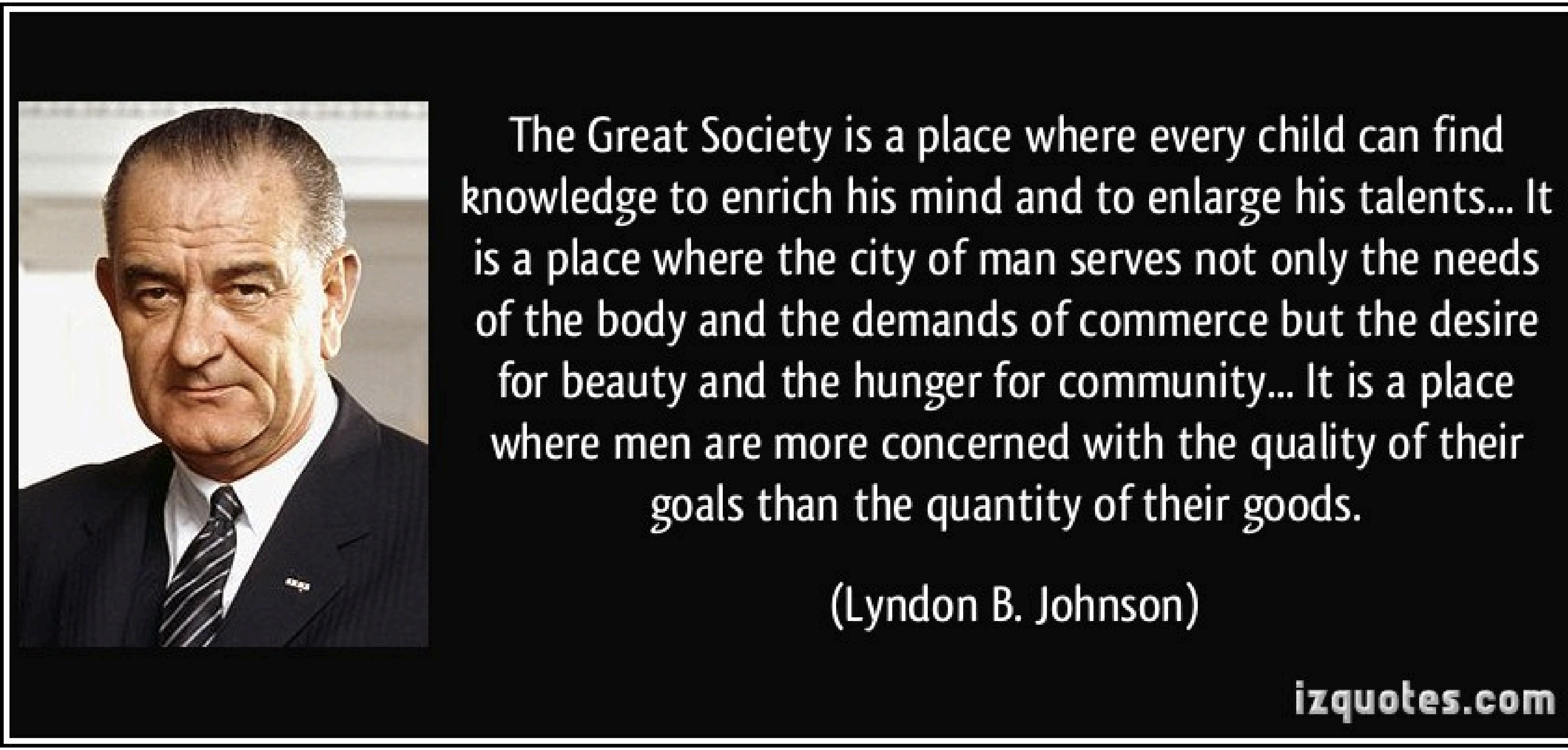
- Three caveats:
  - No guidance for trade-offs: e.g., faithful representation and timeliness; relevance and reliability
  - Conflicts on desirability among prepares, auditors, and users
  - Ambiguity of meaning: e.g., uniformity, comparability, and conservatism
    - Obvious at distance, not so on closer scrutiny
    - What is “uniform” classification in a multi-attribute world?
    - What does comparability mean in a world where no two transactions are identical?

Meanings: Producing Data and Disclosures with Desired Attributes

- Examples:
  - Correlation between financial reports and stock market data; "value relevant" reporting; problems with value relevance
  - Include consolidation of controlled entities
  - Include separate business and geographical segments
  - Include quarterly results
  - Disclosures: financial instruments, off-balance sheet financing, uncertainties, and separate core from non-core businesses
  - In 1994 AICPA (Jenkins Committee): financial and non-financial information
  - Inclusion of forward looking information in financial reports under safe harbor rule, and its consequences
  - Risk of disclosure dump (i.e., excessive disclosure which buries important information in a mass of details) in financial reports

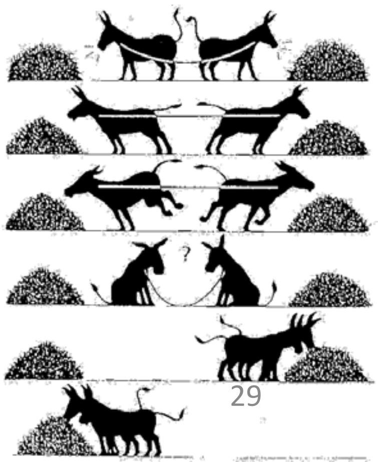
Meanings: Serve Societal Goals/Functions

- Creation of wealth and livelihood
- Promotion of social cohesion and justice
- Creation of markets for physical, financial and human capital that promote economic efficiency
- Creation and operation of organizations to create and distribute social surplus
- Coordination and disciplining of individual participation in organizations and society so personal pursuits do not overwhelm their collective functions
- Discipline alternative and competing sources of information to add stability and predictability to organization.
- Reduce organizations' cost of capital (?)


The Great Society is a place where every child can find knowledge to enrich his mind and to enlarge his talents... It is a place where the city of man serves not only the needs of the body and the demands of commerce but the desire for beauty and the hunger for community... It is a place where men are more concerned with the quality of their goals than the quantity of their goods.
(Lyndon B. Johnson)
izquotes.com

Meanings: Serve Individual Goals

- Enabling participants in an organization to make better informed private decisions to improve their individual welfare
- Four sources of ambiguity:
  - Diverse goals and information demands of groups of participants; may include diametrically opposed interests. Equal weight to all interests?
  - Needs of individuals depend on personal circumstances, change dynamically, unknown and unknowable to others (and regulators)
  - Assumes no interaction among their decisions
  - Demski (1973): Blackwell's fineness condition for informativeness; not likely to be met by any standard, except by Schmalenbach/Goetz/Sorter's "events" approach
    - Open the transactions database to all and let everyone aggregate the data in manner most useful to them



Meanings: Serve Individual Goals

- Simplify by narrowing focus on serving a single group
- Oft-favored group: investors, even shareholders
- Vast literature using the "shareholder perspective" on merits of financial reporting rarely articulates its rationale; venture some guesses:
  - Milton Friedman's widely misunderstood dictum "profit is the only goal of business"
  - transformed into "maximizing shareholder value
  - Sometimes transformed into maximizing share price
  - The leap from goal of business to goal of financial reporting: "maximizing share prices is the goal of financial reporting regulators/standard-setters."
  - But shareholders not the only group in society with relevant interests
  - Informing shareholders for better investment decisions is not the same thing as financial reporting that will increase stock prices and returns
  - Enron's value: $90 or $5 per share?

Financial Reporting as a Ritual

- Continued as a tradition, by convention, with no documentable connection to any putative goals
- Habit,
  - Rain dance
  - Shaking hands or other forms of greetings
  - Birth, wedding and death ceremonies
  - University commencement exercises
  - Faculty meetings
  - Research publications?

Meanings: A Summary

- "Better" in financial reporting means many things:
  - meeting specified societal or individual goals, or
  - possessing some general qualitative or specific statistical attributes and disclosures
- Difficult, even at a conceptual level, to obtain agreement on what kind of financial reports do or can meet criteria within any one or all of these classes. What can be done in absence of broad agreement?
- Given the nature of collective choice and social policy, it is rare for any attempt to clearly identify better financial reporting. Trade-offs must be made in presence of non-commensurate and conflicting within- and across-person objectives. The absence of even reasonable data on preferences, costs and benefits lead to ambiguous conclusions. Indeed, it is a challenge to be both knowledgeable and confident
- Such divergence in social policy is not unique to financial reporting;
- We can look at aspects of economic life outside accounting for help
- Analytical solution of collective choice problem is difficult
- Alternative: look at the institutions and processes; develop a socially acceptable process for defining and developing financial reporting

Means of Improvement

- Three approaches: design, emergence, convention
- Design: requires sufficient understanding of the structure of the problem (e.g., solving a quadratic equation)—use this knowledge
- Imperfect knowledge: effectiveness of successive attempts depends on stability and continuity of the domain
- Emergence from complex, poorly understood interactions through a random process
- Acceptance of practices as conventions

Means

- Over millennia, human societies have developed and employed a variety of social choice mechanisms to solve such problems
- Standards written by a regulatory body are the most frequently employed and analyzed mechanism in the domain of financial reporting
- But not necessarily the best mechanism for all aspects of financial reporting
- Consider the characteristics of the available alternatives:
  - common law
  - popular vote or referendum
  - Legislation and statutory law
  - Courts
  - administrative-regulatory agency
  - self-regulation
  - Markets
- In practice, two or more may be used in parallel.

HENRY II ATTEMPTS TO INVENT THE COMMON LAW

Common Law and Social Norms

- Common law, like language and other social norms
- Emerges from the grass roots
- Most diffused of collective choice mechanisms with minimal role for a centralized authority
- The process of emergence not well-understood
- Does not conform to the demands of a defined time table
- Only matters of broad principle not fine-grained distinctions and technical details beyond the capacity of non-experts.
- Paciolo's text codified the prevailing accounting practices of Italian merchants
- Captured the "common law" of accounting
- Phrase "generally accepted accounting principles" reflects the common law origins of accounting
- Financial reporting largely left this common law until the number and size of publicly owned business enterprises grew
- Demands of growth of larger complex publicly-traded organizations in manufacturing, transportation, utility, and service industries
- Limitations of the common law approach
- GAAP capitalized and appropriated by corporate bodies with legal aut make and impose top-down rules on reporting entities

Popular Vote or Referendum

- Individual citizens have the chance to indicate their preference directly
- May work well social decision mechanisms when the citizens can be presented with just two, or no more than a few, simple, ready-to-understand alternatives such as “X or Y” or “Yes or No”
  - Permitting legalized gambling, sale of alcoholic beverages, and caps on real estate taxes
- As the number and complexity of alternatives increases, efficacy of popular vote is diminished
- Most citizens do not have the knowledge to make an informed choice
- Formulation of alternatives presented to the citizens itself becomes important, and cannot be handled by referenda
- Voters do not comprehend the implications of the collective choice at stake, they become more susceptible to suggestions, advertising, and demagoguery
- Not surprising that financial reporting choices are not made by this method
- “Brexit” referendum

Legislation and Statutory Law

- Statutes are a result of top-down decisions of the ruling dispensation
- In democracy, representatives legislatures formulate, debate, and approve statutes with sufficient support
- “No legislative action” is also a choice, often exercised
- Members of legislatures can argue for the interest of their own or constituents
- Advantage: conflicting interests are articulated, debated, and bargained on in open
- Broad responsibilities of legislatures legislators cannot become knowledgeable about technical complex issues such as financial reporting
- Legislators tend to leave the details to staff
- In the 1990s, US Congress involved in accounting for executive stock options; years for US financial reporting to recover from that intervention
- French government’s intervention with the International Accounting Standards Board in the wake of accounting problems at Societe Generale
- The title of Romano’s (2005) paper “Sarbanes-Oxley Act and the Making of Quack Corporate Governance” is an indication of serious doubts about the wisdom of legislative intervention in the specifics of financial reporting.

Courts

- Unlike legislatures, judges must take a neutral stance
- Under pressure of the arguments from two sides they decide on the basis of law not personal preferences
- Violation of this judicial norms: risk of reversal, loss of public esteem
- Legislators may consider multiple alternatives; courts have two sides
- Courts must decide one way or the other; they cannot punt
- Spacek (1958): proposed a specialized accounting court
- Expertise to handle the finer points and technical details
- Able to use common law to make judgments on financial reports being "true and fair"
- Analogous to determination of "guilty beyond reasonable doubt" in criminal courts
- Reduce administrative and regulatory burdens of making and enforcing rules
- Spacek's proposal did not get traction in the accounting, business or regulatory communities
- Administrative and regulatory approaches to addressing problems of financial reporting have remained and grown in their dominance. Why?

Administrative and Regulatory Agency

- In 1930s, US Congress enacted securities laws, responsibility for regulation of publicly traded companies' financial reporting to the SEC
- Commissioners exercise independence from the government
- Answerable to US Congress for implementing the laws
- Effective regulation (e.g., of insider trading),
- Innovation and experimentation with regulatory methods (e.g., accounting for inflation and for oil and gas exploration)
- Dismal failures (e.g., Enron, WorldCom, Global Crossing, etc.)
- Administrative approach to regulation: worked well with exercise of discretionary powers and judgment in public interest (staffed by angels!); insider trading example
- Contrast with Japan; written rules become road maps for evasion.
- Dilemma: if write only general principles, allowing room for judgment in enforcement
- Defense complains about the lack of specificity in the principles, calls for clarification or "guidance"
- Clarifications shift principles towards in the direction of rules, open new loopholes
- Detail and complexity gradually inches up on demand from the regulatees, reducing scope for judgment on general principles

re to follow this process attracts charges of arbitrariness and absence of due ess in a democratic polity.

Self-Regulation

- Allows a profession or industry to create and operate its own system to regulate and discipline its members
- Most professions have such organizations to set standards, monitor quality and performance, and take punitive actions
- More effective in creating coordination standards because they tend to be largely self-enforcing (examples)
- Not true of quality standards, incentives to cut corners by free riding on industry reputation, when quality not easily observable
- Self-regulatory organizations concentrated in coordination work, and government standards play a stronger role in quality standards (see Jamal and Sunder 2008).
- Self regulation encouraged in US over eighty-years CAP, APB, FASB)
- These organizations worked closely with SEC's Chief Accountant, and rarely issued rules without their pre-approval
- Under this arrangement, following the preparers' constant demands for clarification, the body of written rules that are now supposed to constitute the "Generally Accepted Accounting Principles" has grown to some tens of thousands of pages.

Markets

- Absent externalities, with sufficient competition, markets efficiently direct production and allocation of private goods
- Information in financial report fulfills the two properties of public goods
- Out-of-pocket cost of preparing the reports plus cost of regulatory compliance and induction on decisions
- Point to addressing it as a collective and not as a private choice problem
- Collective choice mechanism does not automatically resolve the difficulties of identifying better reporting methods
- 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.); alternative sets as private goods--a fee or tax from those who choose to be participate
- Fewer people involved in centralized systems; more power of state; decisions can be made and enforced more expeditiously
- Chances of serious errors increase
- Historically US, and more recently EU, have pursued centralization
- Why the prevailing dissatisfaction? Is there dissatisfaction?

What is missing in these meanings of better financial reporting

- Stability
- Robust to financial engineering (Sorites Paradox)
- Learning systems
- Fit with local business and legal environment
- Recognition of endogeneity of transactions and complexity
- Active engagement of academics with issues and debates

Broader Functions of Accounting

- Taxation and collection
- National income
- Monetary policy
- Banking regulation
- Securities regulation
- Employment, wages, retirement, labor unions
- Wealth generation
- Wealth distribution
- Government budgets and financial management
- Government accounting (control of deficits), public pensions
- Cost-benefits of legislative proposals

Balancing the Regime for Improving Financial Reporting

- Regulation and standards vs. culture and social norms
- Specificity vs. purposeful ambiguity
- Threshold vs. continuous approaches
- Authority vs. competition
- Privacy vs. open transactions database (Sorter's "events" approach)
- Confidence in designed social systems vs. humility about our limited capacities

Concluding Thoughts

- No standard is indispensable; people adjust and live without standards
- Issuance of a bad standard can do damage
- How to assess performance standards setters? Biased towards action?
- We do not judge legislatures by the number of enactments
- Refusal or delay to issue new standards is not a weakness
- Let them take time, conduct field studies, and make comparisons
- Our ability to identify socially superior solutions remains, limited and imperfect
- We cannot observe others' preferences; depend on their knowledge, experience, and change
- People, with the help of financial engineers, adjust their behavior to new situations and standards
- Understanding or observation of these changes takes time
- Aggressive standard setting, not based on practice, has costs
- Given the experience so far, some modesty with respect to our ability to devise new accounting methods that improve financial reporting may not be out of place

Perspectives

Thank You.

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1. Universal Standards?

- Universal standards of financial reporting applied across time, economies, industries and corporate size and organizational forms best serve the constituent interests
  - Standardization does save costs and effort, (coordination vs. efficiency benefits; electrical plugs, clothing, cars, street grids, commercial codes, cell phones, software)
  - When does standardization become counterproductive
  - How do we know where to stop?
  - Rhetoric of universal accounting standards using analogy of weights and measures and universal language

2. The Static Ideal?

- There exists a set of financial reporting standards that, once discovered and implemented, will induce corporations and their auditors to prepare the best attainable financial reports
  - Dynamics of the game between financial reporting and financial engineering makes any such a static ideal all but impossible
  - Consider leases, derivatives, design of transactions

3. People or Structure?

- If we select knowledgeable, experienced, self-less, public-spirited, and wise individuals to constitute bodies that devise accounting standards through deliberation and due process, we can improve financial reporting
  - Individuals stand where they sit
  - Much emphasis on the quality of individuals, too little attention to the structure of game they are asked to play

4. Design, not Evolution

- It is possible to construct or discover better financial reporting standards through deliberation in properly organized corporate entities (such as the IASB, the FASB, etc.).
  - Assumes that such bodies can know the consequences of their actions
  - History does not support the proposition
  - Balancing Cartesian design vs. Darwinian evolution
  - Hayek's spontaneous emergence

5. Specialization in Setting Standards?

- Specialist standard setting bodies, standing ready to address new problems, inquiries and requests for clarifications help improve financial reporting
  - Their existence encourages a new "clarification" game targeted at them
  - They must keep a full agenda (performance)
  - Revenue and budget pressures
  - Over time, their output must accumulate to a thick rule book

6. What is Good and Bad?

- Standard setters can tell which standards are better and why.
  - Little evidence that they know, or can know
  - Cost-of-capital is the result of complex interactions among many factors (including accounting)
  - To what extent can we sort these influences by ex ante analysis and research?

7. Standards Monopolies?

- Granting monopoly power in a given jurisdiction to standards written by a given body can help improve corporate financial reporting
  - Informational disadvantage of a monopoly
  - No opportunity for experimentation
  - No opportunity to learn from the experience of alternatives
  - No pressure to do better, or to correct errors

8. Competition and Race to the Bottom?

- A regime that encourages reporting entities to choose among the standards written by competing organizations (and paying them a royalty for the privilege) induces a "race to the bottom" to devise less demanding standards
  - Counter examples (Stock exchanges, bond rating services, appliance standards, college accreditation, bank regulation, corporate charters across U.S. states, etc.)
  - Research on tendency of race to the bottom (or top)?

9. Force and Effectiveness?

- Increase in the power of enforcement behind authoritative standards improves compliance and quality of financial reporting
  - Increased enforcement also increases resources devoted to evasion
  - Do draconian punishments induce better behavior
  - Comparison of evidence from domains of crime, alcohol and drug abuse

10. Effectiveness of Statutory vs. Common Law Approaches?

- The quasi-statutory approach to setting accounting standards dominates a common law approach to financial reporting
  - Evidence?
  - Constitution (U.K., U.S., Europe)

11. Written Standards Dominate Social Norms?

- Written standards backed by power of enforcement work better than unwritten social norms backed only by internal and external informal sanctions
  - Social norms govern great parts of our lives including many aspects of law
  - Insider trading
  - Guilty beyond reasonable doubt
  - Private commercial codes (cotton, diamond trades)

12. Who defends the middle ground?

- The ideal accounting regime would consist of all written standards or all social norms
  - Easier to make the extreme cases for standards or norms alone
  - Difficulty of defending the middle ground where both may co-exist, as they do in many other aspects of life
  - Most of our models tend to be linear and monotonic in decision variables

13. What is New?: Historical Analysis

- Did financial reporting and governance problems originate in the 20th century
  - History tells us otherwise
  - E.g., governance problems of the East India Company
  - Clive, Hastings, and the Company's Court of Directors
  - Evolution of internal directives, financial reporting and auditing

14. Financial Reporting is Getting Better?

- Has eighty years of standardization of financial reports (in U.S.) helped improve the quality of financial reporting?
  – Evidence?
  – Is a thicker (or thinner) rule book indication of better financial reporting?
  – Perfect correlation between accounting and stock returns?
  – How do we judge if our financial reports are getting better?

15. Fewer Alternatives, Better Reports?

- Fewer the alternative treatments the reporting entities are allowed to choose from, the better the quality of financial reporting
  - Fewer alternatives also tie the hands of the management of well-run companies who may wish to signal their confidence, competence and prospects by choosing reporting practices others find difficult to emulate
  - Spence on signaling

16. Auditor's Bargaining Power?

- Do well-specified standards enhance the bargaining power of the auditor vis-à-vis the client? Reduce their legal liability?
  - Standards also encourage clients to demand: show me the rule
  - Reduced reliance on judgment
  - More detailed the standards, greater the part of accountant's work that can be replaced by a computer, and lower the value of the service

17. Accounting & Auditing Games?

- Written standards constrain the tendency of managers, auditors and investment bankers to play accounting and auditing games
  - On the contrary, they encourage and facilitate game-playing by reducing uncertainty about what is, and is not, acceptable
  - 3 percent SPEs => Enron
  - Does codification of GAAP serve as a roadmap for evasion to guide the financial engineers?

18. Individual responsibility?

- Written financial reporting standards strengthen the individual responsibility of managers, auditors, and investment bankers for fair representation
  - On the contrary, they may undermine individual responsibility for fair representation and the big picture by shifting attention to meeting the letter, not spirit, of the specific provisions and their wording
  - John C. Burton (1975) on “true and fair” override

19. Education?

- Written standards make it easier to educate better accountants and attract talent to the profession
  - Written standards may also degrade the class room from reasoning and intellectual debate to rote memorization, reinforce street image of accounting as boring and mechanical
  - They make it less attractive to young talent