

## **Introduce Regulatory Competition to Simplify Financial Reporting<sup>1</sup>**

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I am grateful for this opportunity to join you this evening and share some of thoughts.

The American Accounting Association, founded in 1916, is a voluntary organization of about 8,200 persons interested in promoting worldwide excellence in accounting education, research, and practice. About 25 percent of our members reside outside the United States and about 8 percent are practicing accountants.

Academia, by its nature, is a diverse community, with a broad spectrum of perspectives, theories and analyses. It would be difficult to represent this diversity in these few minutes in any meaningful way. Therefore, I shall take the liberty of presenting some views of my own as a sample. At the end of these remarks I would like to urge the Financial Accounting Foundation, and its units, to avail themselves of a broad range of analyses available in academia by opening their processes to alternative perspectives. In preparing the strategic plan for your organization, exposure to such perspectives would allow you to choose ideas that may facilitate innovation and better achieve your objectives.

Contribution of financial reports to corporate governance, capital markets, government, and the economy cannot be overemphasized. Determining what kind of financial reports would better serve society, and how we could develop such a system of financial reporting has been a major challenge in both the private as well as public sector.

The Financial Accounting Foundation, the Financial Accounting Standards Board, and the Government Accounting Standards Boards have been the pioneers in codifying financial reporting. Their leadership and innovation can be seen in the attempts to replicate the US model in virtually all parts of the world.

Imitation is the sincerest form of flattery, but leadership requires willingness to make even radical changes in light of one's goals and changes in the environment. Determining what kind of financial reports will best serve our society has been, and remains a major challenge. At a policy level, there is the additional challenge of determining what kind of institutional arrangement will generate an efficient system of financial reporting that can accommodate itself to changing global economic environment. In these few minutes, I would like to share with you some possible approaches to meet these twin challenges.

The twentieth century has seen major changes in financial reporting. During the first three decades, financial reports were governed by a system of social norms in business and accounting community. There were few written rules outside the utility and banking industries (because they were subject to federal and state regulation). Appropriateness of accounting for various transactions was actively debated in accounting journals and other professional forums including those of the American Institute of Accountants, in textbooks and classrooms. These debates helped the professional accountants hone their judgments which they could apply to inevitable new transactions as they arose. They also

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took personal responsibility for those judgments; judgment and responsibility, after all, are the essential elements of being a professional.

The stock market crash of 1929, the consequent passage of the federal securities laws, and the creation of the Securities and Exchange Commission changed all that. During the past three quarters of a century, the role of social norms and associated professional judgment has been gradually replaced by written rules and standards. The Committee on Accounting Procedure issued 44 Accounting Research Bulletins during 1939-59. CAP was followed by 31 Opinions of the Accounting Principles Board during 1959-73, and then by the Financial Accounting Standards Board that has, since 1973, issued 159 Financial Accounting Standards. Both the detail, as well as the power of enforcement behind these pronouncements has progressively increased over these seven decades.

This transformation of financial reporting from a predominantly social norm paradigm to an enforced standard regime could be considered the equivalent of shifting from common to statutory law.<sup>2</sup> Of course, any such shift in law would be imprudent, and has not taken place. Common law, as well as judgment and social norms of lay jurors, play a major role in the US system of justice, along with statutory law. It is hard to imagine what our system of law would look like if the common law were jettisoned in favor of statutes. Yet, that is exactly what seems to have happened in accounting over the seven decades since the creation of the Securities and Exchange Commission.

Advantages of codification of financial reporting are well known and I shall not repeat them here. What is less well known is the heavy price paid for shifting the balance away from social norms, judgment and personal responsibility. Increased reliance on codification has landed us in the quagmire of endlessly detailed rules demanded by auditors and their clients, and supplied by the rule making organizations that have little choice but to comply. It has also replaced lively classroom discussions of accounting treatment of transactions by dreary memorization of the authoritative rules. It should be no surprise to anyone that the brightest of university students tend to choose more intellectually exciting majors. Implications of standards for the quality of human talent that will constitute the profession of accounting are written on the wall for all to read.

The rules vs. principles debate of the recent years has, unfortunately, obfuscated this issue, making it appear as if organizations like the FASB and the IASB have a real choice in deciding the amount of detail they should incorporate into their pronouncements. I doubt if any rule maker gets up in the morning trying to figure out how much more detail he or she is going to incorporate into the rules. Once we set up a body whose sole function is to write rules, it inevitably attracts endless requests for “clarifications.” Responding to such requests means writing additional rules. The amount of detail in the

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<sup>2</sup> For example, see Shyam Sunder, “Social Norms Versus Standards of Accounting”, in M. Dobija and Susan Martin, eds., *General Accounting Theory: Towards Balanced Development*, pp. 157-177. Cracow, Poland: Cracow University of Economics, 2005 (<http://www.som.yale.edu/faculty/Sunder/Norms/SocialNorms-StandardsofAccountingGAT3.pdf>) and Shyam Sunder, “Minding Our Manners: Accounting as Social Norms”, Revised November 2005 (*The British Accounting Review*, 37, (2005) pp. 367-387 (<http://www.som.yale.edu/faculty/Sunder/Norms/MindingOurMannersPublished.pdf>)).

rulebook is function of time, not of intent of the rule makers. The reason IASB's rule book is not as thick as the FASB's is that the former has not yet had enough time or budget to do the writing.

In other words, increasing detail and complexity of financial reporting is a consequence of the structure we have set up for the purpose. It follows that the solution to the problem of increasingly complexity could be found in making structural adjustments. Specifically, the rule makers are under constant pressure to add the so-called "clarifying" details to their pronouncements. There is little countervailing force—except their own personal will—to resist such pressures. What can be done to introduce a countervailing force in the structure of the current rule-making institutions?

Competition among standards is a possible candidate to provide such a force. It will not only help place bounds on complexity of financial reporting standards, but also lead to better standards with the benefits of market feedback into the rule-making process. Let me outline how such a competitive process might work and list its advantages over the current regime of standards monopoly (of the FASB in the US and IASB in the European Union).

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

SEC, for example, could allow FASB and IASB's standards to compete in the US as a start, with the possibility of letting others enter the field after some experience with the competitive regime. The EC in the European Union could similarly permit the standards written by these two organizations and, in addition, let companies that so choose, to report using their respective national standards (e.g. British or German standards) as a third choice. Similarly, Japanese regulators, if they so choose, may allow their companies to choose among the Japanese national standards, the IFRS and possibly the FAS. Alternatively, major accounting firms may choose to offer their own respective brands of standards, and get them approved by the regulatory authorities. The regulatory decision to choose permitted standards could be different in different jurisdictions, and subject to change over time. The common feature is that each jurisdiction would allow at least two sets of standards to compete. No jurisdiction would permit a standards monopoly.

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

Standards competition, although a novelty to financial reporting, is common in many aspects of the economy. Stock exchanges, for example compete with different listing and trading standards and fees. Moody's, Standards and Poor's, and Fitch compete on their own bond rating standards, rating services, and fees. Universities and colleges compete with their educational standards, and their accreditation bodies compete with their own respective standards. Federal and state banking regulators compete as do the fifty states of the US with respect to corporate charters for companies. When we look around us, competition among standards is the norm, not an exception, in the economy for several reasons.

Competition yields many benefits. First, it forces organizations to make difficult trade-offs they are otherwise reluctant to make. Competition is the best known catalyst for efficiency and innovation and keeping things simple.

Second, increasing complexity of financial reporting has attracted much attention in the past year. Standards (and royalties) competition will provide the countervailing force to incessant push toward increasing complexity in financial reporting. When they receive a request for "clarification," each standard setter will have to think hard about the possible effect of increased complexity on its royalty revenue stream via reactions of the investment and corporate constituencies.

Third, a system of competitive standards will allow market feedback to enter the decision making process of the rule-writers. Under a monopoly regime where all firms must use the same standards, there is no way of conducting market studies to find out the differences in the consequences of alternative standards. If, for example, the IFRS were adopted in the whole world, we would be stuck in a frozen state, and have no way of adducing evidence to show that a better alternative standard might exist. On the other hand, under a competitive system, one can always conduct comparative studies of companies who choose one or the other set of standards to find out their properties and consequences. In other words, the advantages of competition accrue from our ability to obtain feedback signals from the market and learn not only from mistakes of our own, but also from others'.

Convergence may or may not be the result of such a competitive system. It is quite possible that various standard setting bodies may choose to appeal to different market niches (e.g., multinational firms vs. medium vs. small and local enterprises). Some standard setters may choose to offer multiple sets of standards for different kinds of firms (subject to regulatory approval of course).

Two reservations are often expressed about a competitive system of standards. One is the fear of a race to the bottom—competing organizations diluting their standards to the lowest level in pursuit of royalties. Regulatory approval and oversight is the first protection against the race to the bottom. Second is the evidence from the market itself. As I have mentioned earlier, regulatory competition occurs in many aspects of the economy with little evidence of such a race. In capital markets the risk of such a race is

especially remote, even in absence of regulatory oversight. With over 60 percent of the equity market in the hands of sophisticated institutional investors, it is unlikely that investment would be directed to companies whose financial reports are prepared using “cheap” standards. During the past fifteen years, starting with the Daimler Benz of Germany, scores of large multinational corporations made special efforts to switch to presumably more stringent US standards in order to tap into the US capital market. The market may not be perfectly efficient, but it is not so inefficient as to be susceptible to the risk of a competitive race to the bottom in financial reporting standards.

A second reservation is the fear of confusion from the presence of multiple standards in the market. For the past quarter century, financial reporting has pursued the Holy Grail of uniformity and comparability. Yet, application of the same standards (IFRS) in different countries yields dramatically different results. Even the application of the FAS across industries in US often yields very different results, generating demands for industry-specific accounting standards. The fact is that financial reports are the joint outcome of rules and the economic environment in which transactions take place. Applying same standards to transactions in different environments cannot yield the “same”, comparable or uniform results. That is why the standards convergence project is destined to fail. Moreover, in a world of computer worksheets, investment of a couple of million dollars can create software which can produce relatively accurate estimates of financial reports prepared under alternative sets of financial standards at the touch of a button.

In order to compete internationally, the FAF and the FASB could transform themselves into global organizations. They already have high name recognition and prestige in the financial markets around the globe. However, this advantage is being whittled away rapidly because, as a matter of national sovereignty and pride, it is not realistic to expect many countries in the world to choose the standards written by a US national organization over a organization that not only has “International” in its label but also allows participation of nationals from various parts of world. It would be easy for the FAF and the FASB to remedy this situation and transform themselves to compete internationally.

In today’s globalized economy, US cannot maintain its place in the capital markets of the world by isolating itself. When the possibility of the consequences of Sarbanes Oxley Act for the competitiveness of US markets worry many policy makers, we can hardly do better than to introduce an element of competition and market feedback in helping us discover better systems of financial reporting. The SEC, the FAF and the FASB could benefit by looking for alternative strategies for improving the financial reporting, and for ensuring a continuing US role in developing the financial reporting systems for the future. Given understandable national sensitivities in all parts of the world, insistence on the current monopoly model of standard setting, and the exclusive US control of the FASB, leaves virtually the entire globe as exclusive playground for the IASB.

Academics do not have much to contribute to these important decisions except ideas. My colleagues in the American Accounting Association have many, diverse ideas. You are

welcome to choose those you like. I hope you would look at them, and perhaps even find some of them useful for your purposes.

Thank you.

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