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Luncheon Address**

Why the Top-Down Push for Uniform Financial Reporting Standards

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I am grateful to you, Professors Afshad Irani and President Victoria Shoaf, and the Organizing Committee of the Northeast Regional Meetings of AAA for this opportunity to speak to you this afternoon. It is a special privilege that America grants by accepting those who were born so far away.

Professor Irani suggested that I speak about my research and give an update on the issues before the American Accounting Association. I shall try to do so in two parts of my talk. Obviously, in speaking of research, I express views which are my own, and not of the AAA.

On research, I would like to touch on the wisdom of the top-down push for uniform financial reporting and auditing standards for all public firms in US. I believe that careful reconsideration of the direction of current policies might be useful, especially in light of what we know from research on financial reporting and auditing.

On AAA update, I would like to touch on the report of the Plumlee Committee on the shortage of accounting PHDs, and on three initiatives under consideration at AAA in light of the changing environment of accounting.

So, on the research side, let us start with the project to develop uniform national and international standards for financial reporting

by publicly held firms. Arguments for developing and enforcing uniform national and international standards for financial reporting have been elegantly articulated by many distinguished writers.

US SEC requires all domestic public firms to conform to the standards laid down by the FASB. The European Union and many other countries are well on their way to adopt, implement and enforce the IFRS. Indeed, the question on the table in the world forums of accounting today is not the desirability of uniform world-wide standards, but how we might implement them.

The core arguments for setting forth uniform standards are:

1. They serve as a coordinating device, saving time and effort, just as the rules of the road speed up traffic, and reduce accidents.
2. Public policy should be made through a well-defined, transparent process with clear outcomes.
3. They make auditing easier, and are useful to auditors in their negotiations with their clients.

I believe these are valid arguments.

However, I also believe that public policy should not be made on the basis of the pro-case alone. We should also consider the con case, and then decide by the balance of weight between the two cases.

The benefits of uniform standards are clear, concrete, and immediate. My arguments on the other side are diffuse, hypothetical, and their consequences lie mostly in the future. It is easy to ignore the hypothetical in favor of the concrete. Yet, many of us often conclude, and teach, that hypothetical opportunity costs are a better basis for making decisions than concrete historical costs.

In these few minutes, please allow me to outline six arguments of the con-case on enforcing uniform financial reporting standards by the power of authority. There isn't time to mention other arguments, or to go into details.

At the end of these remarks, I shall propose a system of supervised competition among multiple sets of standards written by independent bodies such as IASB, FASB, or by accounting firms. As investors, companies and auditors could then choose from a set of competing standards. It is possible that, through market competition one set of standards wins out over the others, or several sets may coexist, each attracting its own clientele, without the enforcement by the state. This bottom-up alternative to standards monopoly offers many advantages. Let me explain why.

First, accounting being the language of business, we know that the usefulness of words arises from the uncertainty—the penumbra of variations of meanings—associated with words. Value of any word—“cat” or “house” or “assets”—would be lost if they could only be used for exactly identical objects. “House,” for example, is a general concept, referring to a variety of existing and not-yet-conceived-of constructions. Whether the word “house” is to be used for a particular construction must necessarily remain a matter of judgment of speakers. This centrality of judgment and variation in usage is the essence of all natural languages.

The value of the Oxford English Dictionary arises from encyclopedic collection of the various ways in which a word has been used, not in recommending, nor enforcing its opinion. Variability and dynamics of meaning is the source of vitality of a language. The power of English derives, not from authority, but from the freedom it permits us to communicate. Many natural languages have been, and some continue to be, strangled by the over-jealous advocates of their purity, determined to force

uniformity of usage. No language, accounting included, can flourish under the protective umbrella of punitive authority of state.

Second, accounting is a part of complex social phenomena. The tendency to set standards enforceable through the punitive power of the state is rooted in the Cartesian world view. This perspective presumes that we have enough rational understanding of the world and enough knowledge of designing social structures to achieve the desired ends. There is no evidence, especially in accounting, that our existing or potential knowledge justifies this Cartesian view of the world of business and accounting.

As an alternative to this command-and-control perspective, consider a Darwinian world where complex phenomena emerge through unpredictable events and their poorly-understood interactions. Austrian Nobel laureate Hayek pointed out that the information in our economy is inherently dispersed. It is not possible for any centralized authority—no matter how wise and benign their intent—to know and design social or biological systems to attain specified goals.

After a quarter century of being ignored, Hayek's perspective proved to be right, and the debate on the ineffectiveness of central planning was settled. By trying to standardize accounting from the top, using command-and-control, must accounting refuse to learn from the mistakes of central planning? Must we lose another hundred years in making mistakes we can call our own, before we learn?

Third, the design of social systems is far more complex than of physical systems because the elements of social design—us, the sentient beings—react to the choices and adjust their behavior. People affected by standards take little time to adjust their behavior and redesign their transactions to get around the intent of the slow-moving standard setters. This dynamic game between economic

agents and standard setters is a losing battle for the latter. It is like me sitting in a wheelchair playing tennis against Maria Sharapova (not that it will help much if I was on my feet).

Written standards have been of great value in physical systems, such as computer operating systems and Internet protocol. Yet, absent competition between Apple and IBM PCs, we would still be running DOS of the early eighties.

Fourth, information has interesting qualities. Standard setters may think that they can make users better off by reducing the number of permissible accounting alternatives. But, by making choices, we reveal our secrets; the fewer the permissible accounting choices, the less revealing are our choices. A firm that chooses the accelerated over the straight-line method of depreciation reveals the confidence of its managers in the future of the firm. How else could it credibly reveal such information to investors? The uniformity dogma in financial reporting ignores the signaling value of choices people make.

Fifth, the standards degrade education and training of accountants through their corrosive effect on textbooks, curricula, examinations, and the classroom discourse? They have shifted the focus of accounting education from preparing professionals to think about the best way to deal with any given event or transaction, to what the rule book says. Can we attract talented youth to study a discipline that consists largely of memorizing a fixed set of rules? The power to think is discounted once alternatives to the official creed enshrined in the written standards have been declared out of bounds by authority.

Finally, we should consider the effect of standards on the attitudes of corporate managers and auditors. Standardization is the opposite of making difficult judgments after considering the relevant facts. Standards provide a cover from having to take personal

responsibility for one's judgments. The scandals of the recent years have made clear the corrosive impact of standardization of financial reporting. Over the past seven decades, standards have progressively become substitutes for social norms. Instead, they often serve as road maps for evasion. Rules versus principles is a misleading debate; given the time and budget the FASB has had, I would not be surprised if the IASB's rule book twenty years from now could become just as thick, if not thicker. Their processes are similar and so will be their outcomes.

Few aspects of our lives exclude social norms, and depend so exclusively on written standards as the accountants are attempting to do. No other learned profession relies on standards as accountants are being asked to do. Not doctors, not lawyers, not dentists, nor actuaries. Judgment, not written standard, is the essence of a learned profession. If we do not stop chasing the mirage of uniformity and comparability now, we may soon destroy our profession and any value society places on our services.

Even if you agree with my arguments, you may want to ask me two questions:

What do I suggest we do?

Isn't it too late to stop the speeding train of standardization of financial reporting?

As to the first question, I do not suggest a free-for-all in accounting. I argue, following Professors John Kitchen and William Baxter half-a-century ago, not against standards and definitions, but merely against those written by authority. I agree with them.

Take away the power of authority of the SEC that stands behind the FASB, and the power of EU and an increasingly number of other governments that stands behind the IASB.

In each jurisdiction, authority could choose at least two, perhaps three or four, bodies whose standards would be acceptable. Every company in the jurisdiction would be allowed to choose the set of standards it wishes to follow. These bodies would be financed exclusively by the royalties they collect from the firms which use their standards. The standard setters would effectively compete with each other for these royalty fees, and would be forced to make difficult choices which might, possibly, reduce the cost of capital of the companies that use their standards. OED competes with other dictionaries; so could the accounting standard setters.

Convergence may or may not emerge out of this bottom-up competition, and is not important. Such competition occurs in many regulatory fields including stock exchanges, university accreditation, certification of ships and appliances, etc. There is no evidence that competition would lead to a race to the bottom.

Isn't this late in the day to try to stop this speeding train of standardization in financial accounting? I suggest that it is never too late for us academics to think and share our analyses. And it is never too late to reverse policy if we are convinced that it is not in our best interest.

Moreover, much of what I have to say today was written, more beautifully than I can express, by two great thinkers of accounting in the early fifties. One was late Professor Kitchen, in his article "Costing Terminology" and the other, Professor William Baxter of LSE, in his article on "Recommendations on Accounting Theory" Half-a-century later these two are still the two best analyses of accounting standards.

In the true spirit of open debate on matters of public policy, I realize that in your judgment the pro-case we have heard over the

recent decades from the distinguished proponents of uniform, enforced standards may dominate my con-case.

I only request that you withhold judgment until we have developed, heard, and weighed both sides of the argument, before deciding. I have presented similar arguments to the SEC and the FASB in the US.

Lest these remarks be regarded as an attack on IFRS, FAS, or their creators, allow me to quote from William Baxter:

We thus have cause to be grateful to the drafters of recommendations; and this review should on no account be construed as an attack on them. Obviously, they have devoted much time and care to their task, and have been prompted by a high sense of public service. If harm should in the end come from their work, the blame should attach more to their disciples who have accepted their teaching too eagerly, and have invested it with an *ex cathedra* quality that could not perhaps been foreseen.

It is not unusual in human affairs for a thing to be started with the best intentions, and yet to develop aspects that threaten harm. My plea is that we should now review the good and bad alike, and see whether we cannot guide future growth in directions that are wholly good.”

Those words were written in 1953. Perhaps it is time the debate begins. Thank you.

Next, let me turn to our organization, the American Accounting Association.

As many of you know already, the shrinkage in the number of young people entering the profession of accounting instruction and scholarship has been a matter of concern to many. When this shrinkage is combined with the large number of looming retirements of the baby boomer generation, we could have a serious problem on hand.

The AAA, in cooperation with APLG, appointed an ad hoc Committee to Assess the Supply and Demand for Accounting Ph.D.s. it was charged with responsibility for gathering data about the perceived shortage of new, Ph.D.-qualified accounting faculty.

The Committee was chaired by David Plumlee
Steve Kachelmeier, University of Texas
Silvia Madeo, University of Georgia
David Plumlee, University of Utah (Chair)
Jaime Pratt, Indiana University
George Krull, Grant Thornton (retired)

It operated as a virtual committee over the period May 2004 through December 2005. Three surveys were conducted as part of the study: one for accounting program leaders to assess the expected demand for accounting Ph.D.s, another for accounting Ph.D. program directors regarding the supply of accounting Ph.D. students, and a third targeting current accounting Ph.D. students to assess demographic characteristics and student experiences and motivations.

May I take this opportunity to share with you the highlights from the report:

☞ A taxonomy describing three types of schools was developed for analysis of findings: Ph.D. Schools are defined as those with Ph.D. programs in accounting, Masters programs of any type, and undergraduate accounting programs (19.8% of the respondents) Masters Schools are classified as those with only Masters and undergraduate accounting programs (61.1% of the respondents) Undergraduate Schools have undergraduate programs only (18.1% of the respondents)

☞ The three types of schools (Ph.D., Masters, and Undergraduate) differ significantly in terms of their hiring needs. Masters Schools have a strong preference for hiring to meet specific teaching needs, while schools in the other two categories show a slight tendency to prefer the best candidate irrespective of specialization.

☞ A wide disparity in salaries was found across the three types of schools.

☞ The financial accounting specialty is in highest demand across all three types of schools.

☞ Demand for faculty whose primary responsibility is teaching across all specialties, whether they have a PhD or not, amounted to 36.6% of the total faculty demand, and Undergraduate Schools accounted for 56.0% of that demand.

☞ The most critical finding is while an overall shortage exists, the shortage is acute in the audit and tax specialties (27.1% and 22.8% of demand, respectively).

☞ These shortages should be considered in light of the significant demand for experienced Ph.D.s that was found in the accounting program leaders' survey.

☞ North American PhD students tend to see teaching as a more important motivational factor than research, while non-North American students tend to see research as more important.

☞ The student survey revealed that 48.3% of Ph.D. students surveyed either agreed or somewhat agreed that their program is too stressful, and 29.0% agreed or somewhat agreed that the program is harmful to my physical health.

The report outlines recommendations, and suggests that the issues raised by survey results will require substantial effort from many sources, and that the burden will fall most heavily on the AAA.

The final report is being edited and will be available online in the Spring of 2006 at <http://aaahq.org/about/reports.htm>. I hope you would take the time to read this report about our shared future, reflect and comment on it, and discuss it with your colleagues. AAA will remain engaged with this important issue and I hope you would too.

I would also like to mention two other initiatives underway at AAA. One of them the proposal to create an intellectual property task force. Development of new information and communications technologies (ICT) has shifted the economics of intellectual property. As with other academic associations, production of intellectual property has been a major activity of AAA. The Intellectual Property Task Force will examine the technological, economic, financial, organizational, competitive, and intellectual consequences of the changes in ICT for AAA, and recommend any changes to the Executive Committee, the Council and the membership of the AAA with respect to its financial structure, publications, organization, and other relevant actions.

A second initiative under consideration is the cooperation between AAA and other academic and professional accounting organizations around the world to create a Global Accounting Digital Archive which is freely accessible to all. This project is driven by the belief that capturing and making conveniently available accounting data, records, literature and other archival materials will help advance the discipline of accounting. Further, creating such public goods, which would not otherwise be available, is a high priority responsibility of accounting organizations.

The Global Accounting Digital Archive: A proposal to help advance the discipline of Accounting

Rationale

Data availability, structure, depth, accessibility and cost are critical to accounting research to support basic, applied and practice research. Given new data technologies, there is an opportunity to develop a decentralized, global, cooperative, organized effort to make accounting literature and archives (non-copyrighted or copyright expired or released) readily, instantly and globally available to researchers to stimulate and support accounting as well as business research. Leading professional and academic accounting associations, forming a sponsoring coalition to create this public good, will serve as the catalysts to establish a unique resource on Internet which is unlikely to come into existence otherwise.

Coalition Organizations

1. Organizations interested in improving their understanding of the origins and developing of accounting thought and accounting research (associations, institutes, libraries, museums, businesses, audit firms, etc.) will collaborate as a coalition to create a web portal and web architecture to house multi-lingual accounting archival materials (literature and

records) in digitized form for open and free access world wide. Coalition Organizations will:

- a. identify, digitize, catalog, and upload accounting archival materials in their respective countries at a central host location.
- b. select and encourage people and organizations in their respective countries to engage in this project.
- c. develop ideas on how such a project could be defined, organized, financed, managed, publicized, and maintained on a self-supported basis.
- d. establish the organizations and individuals to lead, convene, initiate and manage the project.

Prospective Coalition Members

1. Academic Accounting Associations (US, Europe, Canada, Japan, China, India, UK, Australia, etc.)
2. Professional Institutes (AICPA, ICAEW, IMA, IAA, CICA etc.)
3. Libraries and Museums (British Library, Library of Congress, University Libraries, New York Public Library, AICPA Library, Chambers Archive, etc.)
4. Museums (with significant document collections)
5. Business firms willing to share their archives with the project
6. Accounting firms willing to share their archives with the project
7. Government organizations willing to share their archives with the project.

Organizations/National Institutes/Individuals Expressing Interest as of this date:

1. American Accounting Association
2. European Accounting Association
3. UK
4. Japan
5. Israel

Forming the Coalition's Exploratory Task Force

1. Identify individuals and institutions with strong research skills and interests, who are capable of developing broad support through global networks
2. Define necessary skill sets: organizational leadership, change management, data
Development, development of accounting thought and institutions, archival knowledge, library and cataloguing ability, digitization, web portal and server technology
3. Build fund raising possibility at initial stage. Get seed money from participating academic organizations

Finally, I would like to share with you my perspective on the function of AAA. The real resources of AAA, as in any academic association, are the ideas and creativity of its 8,000 members. We have formed this association so we can meet, share, and discuss ideas about teaching, research, and the world of business and accounting. Therefore, the primary function of the Association should be help its members achieve their own high potential in ways that would be difficult to achieve individually.

Dependence of AAA on the ideas and initiatives of its members means that we must attract them, especially the younger members, to take up responsibility in the organization. As I try to fulfill my responsibility to form various committees and task forces to serve the AAA during the coming months, it would help me immensely to have the benefit of your suggestions on the names of yourself and your colleagues who may be best suited and interested in participating in AAA's work. Please send your suggestions to the AAA head-office in Sarasota, who will compile the names into lists that will help identify the leadership of our Association.

I am grateful for your time and patience. Thank you.

Second is the question about the consequences—intended and unintended—of the changes that have been made in the auditors’ liability over the past two decades, and continuing efforts to make further changes in US audit regime.

You, and the policy makers in the world, would decide if a single set of financial reporting standards is desirable.

Let us not kill accounting as a language of business.

The extraordinary power of natural languages arises from this variation in, and the dynamics of, the meanings we associate with the words. The power of OED derives from how the meanings listed in the dictionary resonate us. Languages which have tried to wield authority through punishment have a sorry history. that other natural languages can.