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# Better financial reporting: Meanings and means<sup>☆</sup>



Shyam Sunder

*Yale University, USA*

### A B S T R A C T

What is the meaning of better corporate financial reporting? How can financial reporting be improved? There are many claims of shortcomings of financial reporting. Conflicts among these claims point to the political elements of the problem inherent in collective choice in a society. Since “better” depends on the interest group whose perspective is chosen for analysis, politics lies at the heart of accounting policy. The set of possible means of arriving to any agreed upon meaning of “better” includes not only regulation, but also social norms and market competition. Judiciously combining all three approaches, instead of relying on any one alone, may help us improve financial reporting. This paper examines the meaning and means of better financial reporting.

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## 1. Introduction

How should we think about and improve financial reporting? The topic has received much attention during the past century. Perhaps an initial step toward making progress is to recognize that the problem of designing such regimes and standards is not unique to accounting. There are more than five hundred domestic standard-setting organizations in the United States alone and hundreds more in other countries. These organizations are busy defining their technical and business environments and setting standards for everything from ships to shoe laces. In addition, there are international bodies who set standards for things such as radio transmissions across national boundaries. An examination of the accounting regime in the larger context of other products and services in society may

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E-mail address: [Shyam.sunder@yale.edu](mailto:Shyam.sunder@yale.edu)

help us appreciate the costs, benefits, limitations, and economics of developing a better financial reporting regime (Jamal and Sunder, 2011).

What would make financial reporting better? Not surprisingly, there is no unique answer to this question. We examine possible answers based on attributes and goals, as well as financial reporting simply as a social practice. The variety of answers encompasses economic (consequential), political (collective choice in the presence of diversity of interests) and sociological aspects of financial reporting (see KPMG Australia, 2010 as an example).

How we might move in the direction of a specified meaning of “better” in financial reporting is the second major issue we address. Design and emergence are two important ways of thinking about this problem. When we have sufficient understanding of the structure of a problem, e.g., a quadratic equation, it can be solved by applying the knowledge of the relevant domain. When our understanding of the structure of the problem and knowledge about the relevant parameters is incomplete, the design approach yields imperfect answers. In stable environments, successive attempts to solve the problem in light of past experience may help improve the solutions if small changes in the solution cause only small changes in its performance. In unstable or changing environments, and discontinuous domains, even successive attempts at redesign are not guaranteed to improve the results. Solutions, or practices, may simply emerge from a random process of social evolution and become accepted as received practice by the force of convention. We examine the likely consequences of various institutional mechanisms—regulation, norms, and competition—that societies use in the hope of either improving their practices, or simply rationalizing whatever practices may have arisen through history.

Section 2 examines the various meanings of better financial reporting and Section 3 explores the alternative means of approaching the chosen goals. Section 4 suggests some missing elements and Section 5 synthesizes the discussion on a blended approach to improving financial reports.

## 2. What is better financial reporting?

This question yields diverse answers. Issuing calls for “high-quality standards” as some boards with authority are prone to do, assumes that quality can be assessed in an agreed upon manner and that issuance of standards is an important, if not the only, route to better financial reporting. Instead, we begin with a six-way classification of the perspectives used to identify “better” in financial reporting: three based on attributes of financial reporting, two on financial reporting as instruments for serving specified goals, and one procedural. The attribute-based approaches include three variations: (1) pursuit of truth, (2) assessment based on 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 in the reports. The two functional approaches are the efficacy of financial reporting in (1) serving some broad societal goals and (2) the goals of one or more specific classes of participants. A final approach sees accounting simply as an emergent social practice, ritual, or tradition, not rationalizable as a relatively effective means of achieving any specific attributes or goals other than social harmony through acceptance.

Given the nature of collective choice and social policy, it is rare for any such attempt to succeed in clearly identifying what should be regarded as better financial reporting. Trade-offs must be made in the presence of non-commensurate and conflicting attributes, as well as within- and across-person objectives. The absence of even reasonable, much less accurate, data on preferences, costs and benefits leads to ambiguous conclusions. Indeed, caution is necessary because it is a challenge to be both knowledgeable and confident about the merits of alternative formulations; it is tempting to become infatuated with one’s own perspective.

### 2.1. Attribute-based approaches

The most frequently used approach to improve financial reporting is to focus on its attributes. Over years of accounting discourse, truth and fairness are often mentioned. Faithful representation, timeliness, relevance, reliability, verifiability, uniformity, consistency, comparability, cost-benefit efficiency, conservatism, and robustness to manipulation and fraud are also among the proposed attributes of a

preferred financial reporting regime. In the context of governmental organizations, transparency, public accountability, and citizen empowerment and engagement with the organization are often added as desirable attributes of their financial reporting. Statistical properties of data, disclosures, and explanations included in financial reports constitute a third category of attributes.

### 2.1.1. Truth and fairness

When lay people happen to hear about accounting controversies, their usual and understandable reaction is: What is the problem; why should the accounts not tell the simple truth? That the financial reports should truthfully communicate the financial status and performance of an entity is assumed, and has been argued by many (e.g., MacNeal, 1939) and written into the laws of various jurisdictions. Difficulties arise in trying to apply the truthfulness criterion to financial reporting. What is the monetary amount associated with an asset? Two measurements are its historical cost (possibly amortized) and its market value. The historical acquisition cost may be unambiguous, but the amortized cost is not. Market values depend on the market chosen for valuation—for purchase, sale, or use; the timing and the level of aggregation at which the hypothetical transaction whose price is used is to take place. Markets vary greatly in their liquidity and different markets can yield very different representations of the same asset in units of money. Historical costs, as well as market values, have their own claims on truth which have been debated at length in accounting literature. What is true is not always simple, and what is simple is not necessarily true. Pursuit of truth is certainly a valued aspirational goal for financial reporting, especially in presence of blatant lies. It does not help the accountants find their way through the thicket of alternatives when each candidate has some legitimate claim to be true.

Perhaps it is for this reason that truth is often combined with another aspirational attribute—“fairness” in financial reporting. Fairness softens the hard edges of truth by explicitly admitting the role of judgment about the big picture conveyed by the financial report. Not surprisingly, laws in many jurisdictions incorporated “true and fair” as a criterion for good financial reporting. Financial and International Accounting Standards Boards (FASB and IASB) in their single-minded pursuit of market valuation of assets chose a similar sounding label of “fair value” for “market value” accounting. Professional and academic accountants have followed them in this new usage. Unfortunately, to accounting students and lay people, “fair value” accounting sounds deceptively like fairness in “true and fair” accounting, but has little in common with the latter.<sup>1</sup> Instead, the true-and-fair attributes of financial reporting serve in financial reporting a judgmental role based on community standards similar to the role of the “guilty beyond a reasonable doubt” criterion in legal proceedings (Sunder, 2010).

### 2.1.2. Qualitative attributes of financial reports

Many qualitative attributes of financial reports appear in academic and authoritative accounting literature of the past century. Faithful representation, timeliness, relevance, reliability, verifiability (auditability), uniformity, consistency, comparability, cost-benefit efficiency, conservatism and robustness to manipulation and fraud are examples of such attributes. Additionally, in the context of governmental organizations, transparency, public accountability, and citizen empowerment and engagement with the organization are often mentioned as desirable attributes. These attributes have been widely discussed, are well-understood, and considered appropriate, but not always practiced, in determining accounting policy. Little would be gained by elaborating on their meaning here. However, three broad issues deserve brief mention.

No list of such attributes provides the reader or policy-maker with guidance about the inevitable trade-offs among the attributes. E.g., how much timeliness can be sacrificed in favor of how much accuracy; or what is the right balance between representative faithfulness and conservatism. In the

<sup>1</sup> Indeed, (U.K.) Queen's Counsel George Bompas concludes: “In the circumstances, so long as UK companies' legislation relating to company distributions remains as it is at present, it seems to me to be difficult to assert that accounts which fail to enable a determination of what is or is not available for distribution by reference to amounts stated in them can give a true and fair view of a company's assets and liabilities, financial position and profits or losses, as they will fail to meet one of the central purposes for which the accounts are required.” (<http://www.lapforum.org/archive/files/BompasFurtherOpinionSignedCopy.pdf> accessed March 4, 2016). Also see Quinn (2015).

absence of quantified measures and optimal rates of substitution, these qualitative measures also belong to the class of aspirational attributes of true-and-fair discussed above.

Second, an accounting attribute which is desirable to some may not be equally valued, or may even be harmful, to the interests of other participants such as preparers, auditors, and users of financial reports. Third, some of qualitative characteristics, such as uniformity, comparability, and conservatism, carry a broad spectrum of meanings with them. Close scrutiny draws attention to their ambiguity which is not easily discernible from a distance. For example: What does uniformity mean in a multi-attribute world? “Similar treatment of two transactions which have any similarity” and “dissimilar treatment of two transactions which have any dissimilarity” yield radically different solutions to the problem of uniformity (Sunder, 1984, 1997, Chapter 9). What does comparability mean in a world where no two transactions are exactly alike? (Weinberg, 1992, Chapter 2, “On a piece of a chalk”).

### 2.1.3. Statistical attributes

Disclosures and statistical attributes of their contents is another approach to defining the meaning of better financial reports. Perhaps the best known of such proposals is to consider a larger correlation—positive or negative—between accounting income or returns and stock market returns to be a measure of better financial reporting under the catchy but misleading label of “value relevant” reporting. Value relevance implies a causal direction, and it may generate statistical correlation; however, statistical correlation does not imply causality.<sup>2</sup>

It has been suggested on various occasions that financial reports should (1) consolidate controlled entities, (2) separate business and geographical segments, (3) be published every quarter, (4) disclose financial instruments, off-balance sheet financing, uncertainties, and (5) separate core from non-core businesses. AICPA’s Jenkins Committee (1994) recommended that reports include not only financial but also non-financial information. After the practice and the regulatory regime had long discouraged inclusion of forward-looking information for the fear of fraud and lies, the Jenkins Committee and US Congress encouraged inclusion of such information in corporate financial reports under a safe harbor rule (i.e., no penalties if such information is subsequently proven wrong or misleading).

Expansion of disclosure is not without its own costs in the form of attention of the users. If disclosures were machine readable and interpretable, processing of additional disclosures in financial reports would present little difficulty for the users. But all disclosures are not easily and meaningfully classified into a standardized classification scheme (such as the much-touted XBRL) and descriptive disclosures add significantly to the cost of processing additional pages of details by human beings. Enron is said to have disclosed thousands of special purpose entities it created to “hide” its indebtedness but the extraordinary detail itself became a reason why most analysts failed to notice Enron’s high leverage.<sup>3</sup>

## 2.2. Goal-based approaches

Instead of trying to specify a set of attributes, we can set the goals sought to be served through financial reporting. This can be done either at societal or individual levels, each with its advantages and difficulties.

### 2.2.1. Serving societal goals

That financial reporting should serve broadly defined societal goals such as creation of wealth and livelihood, promotion of social cohesion and justice, and creation of markets for certain types of physical, financial and human capital that promote economic efficiency is widely supported.<sup>4</sup> However, like

<sup>2</sup> Also see Rabins (2013) on causal inference and Sunder (2011a, Section 4.7) on the problem of making causal inference from statistical data in accounting.

<sup>3</sup> See Swartz and Watkins (2004, p. 373) for deliberate complexity and Bloomfield (2012) for a “Pragmatic” theory of disclosure.

<sup>4</sup> However, support for increasing financialization of society, in the form of creating markets in which all kinds of capital may be exchanged for money, is hardly universal. Financialization has its limitations and has been the subject of severe criticisms, especially in the aftermath of the Atlantic Financial Crisis of 2007–2010. Although this paper does not that pursue that line of argument, it deserves considerable attention to its merits.

other such aspirational propositions, a broad agreement on which financial reporting regimes better attain such goals is unlikely.

The high material wellbeing of today's society is a result of organizing individual talent and effort in large and small groups, and linking them so they can interact in flexible, transient, but significantly predictable ways (making it possible to make reasonably useful plans). 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 (excess of the value of the output over the sum of the opportunity costs of all inputs including externalities). This surplus is the net economic contribution of an organization to society (Sunder, 1997, Ch. 2; 2008).

Accounting and financial reports are necessary for organizations to attract capital and human resources and to ensure that the contributors have a reasonable chance of receiving their share of the surplus in exchange for their respective contributions. In this sense, financial reporting is necessary for organizations, including society as a whole—another larger organization—to sustain itself.

When individuals seek their respective goals, financial reports help organize them into coordinated networks, inform them about the functioning of the network and discipline individuals so the pursuit of their personal interests does not overwhelm the network's collective functions. Financial reporting disciplines many individual actions; it also provides them access to alternative and competing sources of information. In this sense, financial reporting helps create stability and adds an element of predictability to the functioning of organizations.

It has often been claimed that an important function of financial reporting in business organizations is to help reduce their cost of capital. This argument is vulnerable to two objections. First, what is cost to a business organization is profit to its investors. To claim that financial reporting should be chosen to reduce the cost of capital amounts to claiming that it should be chosen to reduce the returns to investors. Second, cost of capital is just another price (a rate of exchange) of a factor of production and it has not been shown that lowering the price of capital (or of potatoes, for that matter) improves social welfare because society includes both the consumers as well as the producers. Who can say that, in setting social goals, the interests of one dominate, or should dominate, the interests of the other side in a factor market?

### 2.2.2. *Serving goals of individuals*

Addressing the interests of various classes of participants in an organization is another approach to better financial reporting. Enabling these classes to make better-informed private decisions of their own is mentioned often. In this decision-making perspective, it is assumed that the participants have their preferences and objectives, which they combine with information from financial reports and other sources to formulate and solve their decision problems within their opportunity sets. More broadly, this meaning of better financial reporting can be said to help the participants of an organization to improve their individual and collective welfare.

Four sources of ambiguity arise in this meaning. The goals and information demands of various groups of participants do not coincide across, and even within, the members of groups. It is difficult to choose a financial reporting system to serve a diverse assembly that may include diametrically opposed interests. A second problem is that information needed by individuals may depend on their transient personal circumstances which are unknown and unknowable to the selectors of the financial reporting system.<sup>5</sup> Third, individual decision usefulness criterion for better financial reporting assumes independence, i.e., little or no interaction among their decisions. But interactions among rational decisions of “better informed” individuals may yield less desirable outcomes for some others, even for all of them, as compared to outcomes from not-so-well-informed decisions. Fourth, as Demski (1973) points out, from Blackwell's theorem, we know that a better information system for individual decision must be strictly finer and this fineness condition is not likely to be met by any standard. Sorter's (1969) events approach to accounting is an open-ended alternative to the popular but largely ineffective standards approach.<sup>6</sup>

<sup>5</sup> Personal or group claims of their circumstances have to be credible before their inclusion in policy-making becomes justifiable. Arguments made in position papers and lobbying cannot be taken at their face value by regulators and law makers.

<sup>6</sup> Sorter (1969) proposed that the users be given access to a database of relevant events so they can aggregate the details and produce financial reports in a manner that best serves their own diverse needs.

These difficulties with defining better financial reporting guidelines in terms of information for decision making for a diverse body of individuals has often been sought to be ameliorated by narrowing the presumed target of financial reporting to a single group—investors, and sometimes narrowed even further to shareholders. Although the vast literature that adopts this “shareholder perspective” on the merits of financial reporting does not articulate its rationale, we can venture some guesses. The first and most plausible reason lies in the large following of Milton Friedman’s widely misunderstood dictum “profit is the only goal of business,” which has been transformed 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 interests regulators and standard-setters 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>7</sup>

### 2.3. Financial reporting as a social practice or ritual (“Rain Dance”)

A ritual is an invariant sequence of actions performed in religious, social, organizational, and individual contexts either without a stated purpose or without an empirically verifiable link to its purported purpose. University commencements, tribal rain dances, visits to places of worship, shaking hands at the time of being introduced, or saying goodbye when parting company are a few examples of rituals practiced in societies across the world. According to Bell (1997), rituals may be prescribed by the traditions of a community and characterized by formalism, traditionalism, invariance, rule-governance, sacral symbolism and performance. Sceptically, practices of financial reporting also can be seen as a ritual full of symbolism but 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 rain dance is not assessed by whether precipitation follows the ritual; other measures such as the number of participants, the beauty of the costumes, and the sumptuousness of the feast that follows replace the objective criteria. Handshakes and the ritual greeting “How are you?” are typically returned in kind without an answer and assessed by their firmness and eye contact. Similar statements can be made about prayer, university examinations and grades.

In summary, “better” in financial reporting could be defined by various kinds of attributes, social or individual goals, or simply as a social acceptance. It is difficult, even at a conceptual level, to obtain agreement on what kind of financial reports do or can meet the criteria within any one of these three broad classes, much less in all six sub-classes. What do we do in the absence of agreement?

Without broad agreement across and within its constituent groups, it is an understatement to say that the meaning of “better” in financial reporting remains far from obvious: better in what sense and for whom are unresolved issues. Such divergence in social policy is hardly unique to financial reporting; it is common to most aspects of law, regulation, and other problems of collective choice (e.g., Arrow, 1963). Financial reporting includes elements of collective as well as private choice. Looking at aspects of economic life outside of accounting may help.

Analytical derivation of solutions to problems of collective choice is difficult in most circumstances for the same reasons outlined in the problem of selecting criteria for “better” accounting in the preceding section. Process is an alternative to criteria. Looking outside accounting, 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. Perhaps societies find it easier to arrive at agreement on processes and institutions behind a Rawls (1971) “veil of ignorance” because, at the time the process is chosen, specific issues, possible actions and their consequences for various individuals and groups are not known.

<sup>7</sup> In the wake of the financial reporting scandal at Enron in 2001, the stock price dropped from \$90 to less than a dollar. According to one estimate, Enron should have been worth about \$5 at the time. Whether the shareholders lost \$85 (=90 – 5) or \$4 (=5 – 1) per share is a matter of some debate. Whether shareholders are interested in financial reports that accurately reflect or maximize the value of their stakes should not be, but remains, controversial.

### 3. Processes and institutions for collective choice in accounting<sup>8</sup>

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 written standards issued by a regulatory body are the most frequently employed and analyzed mechanism in the domain of financial reporting, they are neither the only nor necessarily the best mechanism. At the outset, it is useful to consider the characteristics of the available alternatives in eight broad categories—common law, popular vote or referendum, legislative or statutory, judicial, administrative regulation, self-regulation, and market—recognizing that in practice, two or more may be combined or used in parallel.

#### 3.1. Common law

Common law, like language and other social norms, is an emergent phenomenon. It is diffused in the sense that almost the whole community participates in its development without being conscious about the process. Central authority's role is minimal. Emergent processes are not well-documented, nor do they conform to the demands of a defined timetable. They are often matters of judgment over broad principles that do not call for fine-grained distinctions and technical details. Paciolo's text written in the fifteenth century codified the prevailing accounting practices of Italian merchants and captured the common law of accounting. The popular phrase "generally accepted accounting principles" reflects the common law origins of accounting and financial reporting.

Financial reporting was largely served by common law until the number and size of publicly-owned business enterprises grew to account for a significant proportion of economic activity. Rapid growth of larger, complex, publicly-traded organizations in the manufacturing, transportation, utility, and service industries placed additional demands on financial reporting systems that could not easily be met by the common law approach. In the twentieth century, the GAAP label for generally accepted accounting principles was capitalized and came to be used by corporate bodies created with legal authority to make and impose top-down rules on reporting entities.

#### 3.2. Popular vote or referendum

In making collective choice by popular vote or a referendum, individual citizens have the chance to indicate their preferences directly. Referenda can work reasonably well as social decision mechanisms when 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." The permitting of legalized gambling, the sale of alcoholic beverages, and caps on real estate taxes are examples amenable to this type of collective decision-making. As the number and complexity of alternatives increases, efficacy of popular vote is diminished because most citizens do not have the knowledge base to make an informed choice, and formulation of alternatives presented to the citizenship itself becomes an important part of decision-making 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 are not made by this method, and are unlikely to be made in this manner in the future.

#### 3.3. Statutes and legislation

Statutes are the complement of common law and result from top-down decisions of the ruling dispensation. In democratic systems, formulation, debate, and approval of statutes is entrusted to a legislature consisting of representatives elected by constituents to speak on the latter's behalf. Whether the legislature passes a statute depends on the support for such action from a sufficient number of its members, depending on its rules of procedure. If it operates by a majority rule, for

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<sup>8</sup> Also see Sunder (1988).



example, it can take no action unless one of the proposals on the table gains majority support. But “no legislative action” itself is also a choice in favor of the status quo.

Members of a legislature are not constrained from arguing for proposals that favor them or their constituents, and most of them are not shy to do so. One advantage of legislative decision-making is that the conflicting interests in the house are articulated, debated, and bargained about during the process. Little of the reasoning and motivations behind conflicting positions is left hidden under the rug, and all sides, not just two, get the chance to air their views on the issues at hand. Given the broad responsibilities of legislatures across all issues in the political domain, few legislators can be expected to have the time, ability, or inclination to become knowledgeable about technically complex issues such as financial reporting. Even when legislatures engage with such issues, they rarely understand the issues, and tend to leave the details to staff. The results can be random shots or worse. In the 1990s, the US Congress got involved in accounting for executive stock options under lobbying pressures from Silicon Valley, and it took the Dotcom bust and many more years for the US financial reporting system to recover from that misguided intervention and to put a reasonable method of accounting for employee stock options into practice (Financial Accounting Standard No. 123R issued in 2005). The French government’s intervention with the International Accounting Standards Board in the wake of accounting problems at Société Générale had similar effects. [Chambers et al. \(2010\)](#) and [Romano \(2005\)](#) express doubts about the usefulness of direct legislative intervention in financial reporting.

### 3.4. Courts

Unlike the legislatures where the members are free to argue for their own or constituent interests during their deliberations on statutes, judges in courts must take a neutral stance. While judges also are under pressure to hear arguments advanced by the two sides before them, they must decide on the basis of common or statutory law, and not on their personal preferences.<sup>9</sup> Any obvious violation of this judicial norm carries significant risk of reversal on appeal in higher courts and loss of public esteem for the court. In contrast with the legislators considering multiple alternatives, courts typically have only two sides before them, and must decide one way or the other; they cannot punt. Courts can deliberate on a case for weeks or months and have the benefit of expert advice in deciding a case.

Judicial and legislative mechanisms rarely stand alone and are frequently accompanied by bureaucratic support. However, some standard-setting mechanisms are almost purely bureaucratic. I return later to some problems of bureaucratic mechanisms.

[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. Such a court would have developed the 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 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 a court would help reduce the rapidly expanding administrative and regulatory burdens of making and enforcing rules. But the accounting-as-written-rules perspective has so dominated the debate that Spacek’s proposal has not received much traction in the accounting, business, or regulatory communities in over half a century. Instead, administrative and regulatory approaches to addressing problems of financial reporting have remained firmly entrenched and grown.

### 3.5. Administrative and regulatory agency

In the 1930s, the US Congress enacted legislation to hand the responsibility for regulation of publicly traded companies’ financial reporting to the newly created Securities and Exchange Commission

<sup>9</sup> At least in theory, this is supposed to hold. However, the intensive political debate that started after the death of U.S. Supreme Court Justice Antonin Scalia and his role during his tenure in the Court suggests that, in practice, personal preferences of the judges may also play an important role.



(SEC). Under the US system, once appointed, commissioners of the regulatory agency exercise a great deal of independence from the administrative apparatus of the government during their term in office. These agencies are answerable to the US Congress for the laws they are charged with implementing. Under this administrative arrangement, we have seen regulation (e.g., of insider trading), innovation and experimentation with regulatory methods (e.g., accounting for inflation and for oil and gas exploration in the 1970s), as well as dismal 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 are allowed to, and in fact do, exercise their discretionary power and judgment in public interest. For example, the refusal of the SEC to define insider trading beyond “trading on material non-public information” has enabled it a measure of success in prosecuting many such cases. The agency has been under pressure to clarify the meaning of “trading on material non-public information.” Had it yielded to that pressure, as did regulators in Japan who wrote down the definition in several pages, the SEC would also have failed to go after wrong-doers who can use such definitions as a road map for evasion.

This is a basic dilemma for regulators. If they write down only general principles, they allow themselves room for exercise of their judgment to bring enforcement actions when they see a violation of the principles. The defense complains about the lack of specificity in the principles, and calls for clarification (or “guidance,” a frequently used term in the context of financial reporting). Users complain of the difficulty of comparison among the diverse interpretations preparers give to the promulgated general principle. However, every clarification shifts principles in the direction of rules and opens up new loopholes in regulation. Detail and complexity gradually inch up on demand from the regulatees, making it progressively more difficult for the agency to exercise judgment on general principles of reporting. The failure to follow this process brings charges of arbitrariness and absence of due process which are difficult to rebut in a democratic polity (Sunder, 2011b; Dye et al., 2015).

### 3.6. *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 under “light-touch” oversight of a government regulator. 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 because they tend to be largely self-enforcing. If the Association of American 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 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 discernable to their customers. For this reason, self-regulatory organizations tend to be concentrated in coordination work, while government standards play a stronger role where quality is concerned (see Jamal and Sunder, 2014).

Over its eighty-year history, the US SEC has encouraged creation of self-regulatory organizations in financial reporting and has 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 and the Accounting Principles Board (APB). In 1972, the APB was replaced by another self-regulatory organization—Financial Accounting Foundation/ Financial Accounting Standards Board (FAF/ FASB)—with broader representation from outside the accounting profession which nevertheless retained a majority of seats in the FASB. These organizations worked closely with the SEC’s Chief Accountant and rarely issued rules without informal pre-approval by the SEC staff. 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.

### 3.7. Markets

In the absence of externalities and with sufficient competition, markets can offer an efficient solution for the problem of producing and allocating private goods.<sup>10</sup> Information contained in financial reporting has both the zero marginal cost and the non-excludability properties of 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 firm must maintain in any case for managing its operations and exercising internal control. Perhaps a larger cost takes the more difficult-to-quantify forms of regulatory compliance and the changes in behavior of management induced by financial reporting regulations. Consideration of these public good aspects of financial reporting information points to addressing it as a collective rather than a private choice problem.

As already discussed, handing the problem over to one of the collective choice mechanisms 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 can be made into private goods by charging a fee or tax from those who choose to participate in them.

As we move from common law toward a bureaucratic mechanism, 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 serious errors increase. Historically, this has been the direction of change in the United States. In recent decades, the European Union appears to have followed suit. Given the prevailing level of dissatisfaction with the current financial reporting regime, we need to examine where we might have gone wrong in conceptualizing the meaning of better financial reporting and the means of achieving that end.

## 4. What is missing in the meaning of better financial reporting?

### 4.1. Stability of regime

In exploring the attributes of “better” financial reporting, some important attributes are rarely mentioned. Stability of the reporting regime is one of these attributes. The bureaucratic mechanisms now in place try to identify new financial reporting problems and devise new rules which purportedly address them (Sunder, 1981). The FASB even has an Emerging Issues Task Force to help alert the Board to new problems. In the attempt to fight the financial reporting fires, it is easy for such organizations to lose sight of the value of the stability of the financial reporting regime. In their more than fifty attempts over some sixty years, regulators have not yet succeeded in getting any significant number of long term leases capitalized on corporate balance sheets. Yet, they keep trying with the most recent new pronouncement on the subject appearing in February 2016. After so many years, it is possible that most users of financial reports have already adjusted their analyses to the absence of capitalized values of long term leases on corporate balance sheets. Assigning some value to the stability of a financial reporting regime would increase the likelihood that the preparers and users of financial reports would find a set of strategies which are in mutual equilibrium and give rule makers an opportunity to take more vacations.

### 4.2. Emergent practices

The Hayekian model of extended order emphasizing the informational efficiency of emergent practices from social evolution has been largely absent from recent accounting thought. Most accountants, academics included, tend to believe that top-down written standards are the only way of improving financial reporting. Practitioners no longer share George O. May’s trust in the wisdom encapsulated in accounting practices that arise from everyday experience of dealing with new transactions and situ-

<sup>10</sup> Private goods are defined in contradistinction to public goods (zero marginal cost of producing additional units and non-excludability of the non-payers from the benefits).

ations in good faith.<sup>11</sup> For some reason, the repeated failures of the top-down solutions proposed and enforced by the standards boards have hardly dented this attitude. Lawyers run the SEC and advise accounting firms. They recognize common law as an essential part of their own domain. Yet, they show little faith in accountants using a balanced set of written rules and practice-based judgment. Perhaps a case for a greater role for emergence in accounting practice remains to be made (e.g., see [Jamal et al. 2003a, 2003b and 2005](#) for evolution of privacy in e-commerce). We live in a world where information is dispersed among people, each of whom learns of information as a by-product of work and life. It is impossible for any central authority to gather this information in one place to make centralized decisions. Emergent systems have a much better chance of continually incorporating changing information in the hands of millions of people to become efficient learning systems.

#### 4.3. *Robustness to financial engineering*

Better financial reporting should also exhibit some robustness tied to financial engineering. As mentioned with the example of lease accounting in Section 4.1, financial reporting is no match for financial engineering and writing increasingly detailed standards only makes it worse. [Sunder \(2011b\)](#) and [Dye et al. \(2015\)](#) point to the importance of robustness as an attribute of financial reporting that needs more attention. In their attempts to follow economic theories developed for purposes quite different from the functions of financial reporting, accountants repeatedly fall prey to Sorites Paradox.<sup>12</sup> By specifying “hard coded” thresholds (such as 90% of the value of the leased asset), accounting rule-makers only set themselves up for failure.

The financial reporting regime and the transactions carried out by reporting entities are mutually endogenous. A change in reporting regime invites the design of new transactions, and vice versa. We cannot improve financial reporting without explicitly considering the mutual dependence.

#### 4.4. *Relationship to business and legal environments*

Last two decades' campaign for international standards as the main instrument for improving financial reporting has pushed to the background the dependence of accounting practices on local business and legal environment. Financial reporting does not exist in a vacuum. Every society and economy has important features that are unique to its environment. It is certainly possible for an architect to build the same house in the arctic and the tropics. But as long as the two environments remain distinct in important ways, the usefulness of pursuing this strategy in financial reporting remains questionable.

### 5. **Concluding remarks**

No matter what institutional mechanism we devise to set accounting regimes, our ability to identify socially superior solutions will remain limited and imperfect. Others' preferences and circumstances are not known, and they change continually. People adjust their behavior to changes in the regime in difficult-to-anticipate ways. Accounting regulators' record in assessing the consequences of their actions is not impressive, especially when the new rules are complex. For this reason, aggressive top-down written rules can have only a limited role, in combination with bottom-up social norms that arise from practice and experience.

A balanced approach to improving a financial reporting regime should combine multiple approaches along several dimensions mentioned earlier. The desired attributes and goals of society and individuals have to be considered with the culture and norms of society ([Sunder, 2005a, 2005b](#)). To achieve such a balance, institutions of accounting can depend on practice, bureaucracy and market forces. The bureaucratic structures of the rule-makers could benefit from toning down their unjustified level of confidence

<sup>11</sup> [May \(1943\)](#): “The rules of accounting, even more than those of law, are the product of experience rather than logic.”

<sup>12</sup> Sorites Paradox or Paradox of the Heap refers to the difficulty of defining terms such as “heap.” If you consecutively take a grain of sand out of a heap of sand, what is left behind is still a heap, until a point comes when it is no longer a heap. When do we reach that point?

in divining better financial reporting rules and set up arbitrary thresholds for financial engineers to play with. In their over-confidence, accounting rule-makers have ignored the database approaches (such as Sorter's "events" approach to accounting) for too long. Although Sorter's proposal was technologically infeasible at the time it was proposed, the world has changed during the past half century. With new technologies being proposed from other parts of the economy (e.g., blockchain accounting; see [Quartz, 2016](#)), it is possible that accountants may already have missed their opportunity. Introduction of some competition might be a timely wake-up call for rule-making monopolies ([Sunder, 2002, 2011a](#)).

The introduction of competition in regulatory regimes often brings up fears about a race to the bottom. Like its other forms, this competition also calls for regulatory oversight of its own, because managers, investors and auditors push financial reporting in directions that serve their own respective interests. Dominance of any interest group is unlikely to serve society well. In market competition, attempts of various parties to seek their own interests generate compromises on form and content of financial reports acceptable to them. Regulatory oversight ensures that the outcome is not unduly distorted in markets for goods and services, as well as rules. In the automobile market, for example, dynamic competitive interaction among manufacturers and customers aggregates their preferences, technologies, and information to determine the kinds, quantity and price of cars made, offered, and bought. A light-touch regulatory layer on top of this competition sets rule of competition, safety and environmental compliance. In setting the accounting regime, competition among rule-makers is missing, and the heavy-handed regulatory layer gets into too many details—akin to setting the color and size of cars. A call for competition is not advocating to eliminate all oversight, only to allow more room for innovation and variation. Stock exchanges and universities are good examples of this model. [ICAEW \(2009\)](#) is an example of continuing discourse on accounting innovation.

Written standards are not always necessary; none exist for most aspects of our lives where social norms prevail. Issuance of a written standard can even undermine the established norms and induce dysfunctional behavior. The number of laws passed does not measure the efficacy of a legislature and the number or pages of written standards does not indicate the quality of the accounting regime. A proactive rule-maker is not necessarily a good rule-maker. It is difficult to know what is meant by "high quality" of accounting standards.

Principles-based standards avoid detail in favor of letting each organization make its own decisions by exercising judgment. In such a regime each firm makes its own independent, and therefore diverse, interpretation of such general principles. In other words, principle-based standards reduce harmonization. This is the fundamental weakness of the claim that principle-based standards helps to create more comparable financial reports. Shared expectations of social norms help induce order in our lives; there is little reason to think that written rules alone are an effective means of creating an accounting order.

The setting of an accounting regime is not a mere technical matter. Technical expertise is necessary but not sufficient. In accounting, as in other areas, it involves consideration of social efficiency—a technical matter—and of distribution of gains, which is a political matter. As in all political matters, people can differ without any one being wrong. The quasi-judicial structure of the FASB/IASB and other boards, along with their accountant staffs, emphasizes the technical aspects of their task. Even as they act politically, they remain reluctant to admit to the political (i.e., distributional) aspects of their choices. A quasi-legislative system will shift some weight toward political part; its technical inconsistencies need not surpass the level of the past four decades. Appointment of parties without identifiable interests in the choice of the accounting regime (e.g., accounting professors) as voting members tends to detract from the political aspects of the work. Their role in such a quasi-legislative structures is best restricted to advisory and staff functions.

Unwillingness to issue new rules without the benefit of field trials hinders the rule-makers' ability to deal with transactional and environmental innovations. It is no more reasonable to expect that accountants discover efficient responses to innovations than physicians cure newly discovered infections or engineers fix the space shuttle overnight. The imperfection of our knowledge calls for field testing of a variety of solutions to new problems. Speeding up the process imposes the large cost of making mistakes and might result in confusion in financial markets. Accountants should not worry too much that the SEC may not accept a slower pace of response to new issues. They can remind the Commission of its failure with quick fixes. Before intervening in accounting for employee stock

options, the Commission tried to implement reserve recognition accounting for the oil and gas industry in 1978 (Accounting Series Release 253). It was forced to backtrack in 1982 because of the subjectivity and large swings in performance metrics of the reporting entities engaged in oil and gas exploration and extraction.<sup>13</sup>

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<sup>13</sup> See Magliolo (1986) and AccountingOnion.com (2008).