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**Can Financial Accounting Regulators and Standard Setters  
Get (and Stay) Ahead of the Financial Engineers?**

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## 1. Introduction

Can financial accounting regulators and standard setters get (and stay) ahead of the financial engineers?<sup>1</sup> The short answer is no. If approached as a design fight between the standard setter and financial engineers, the standard setter is bound to lose. This lecture explores alternative approaches that could be taken by standard setters—the Financial Accounting Standards Board (FASB) in the United States. I then discuss the role of securities regulators—the Securities and Exchange Commission (SEC) in the U.S.—and the importance of ensuring that regulation reinforces the approach taken to standard setting and vice versa. I apply recent research on incentive theory (mostly multi-agent incentive theory) in discussing alternative approaches, particularly in my discussion of regulation.

## 2. Standard Setting

One criticism of accounting standards is that classification and recognition discontinuities (for example, recognition thresholds) provide ammunition for financial engineering. If we make the accounting for transactions closer to their underlying economics, so the argument goes, incentives for manipulation would be ameliorated (Herz, 2013). In operationalizing the ambiguous notion of accounting that better reflects the economics of transactions, there is usually an appeal to continuity (that small changes in the attributes of a transaction should not

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<sup>1</sup> This lecture was developed from a presentation for a panel discussion at the American Accounting Association's 2012 Annual Meeting on the same subject. The other panelists were Bob Herz (former chairman of the FASB and former financial engineer before that), Ron Dye, and Shyam Sunder. Ron, Shyam, and I are writing up our part of the discussion in Dye, Glover, and Sunder (2013). There is some overlap, with this Lecture borrowing freely from that paper, although the Lecture takes a more game-theoretic approach to the problems. I thank Masako Darrough for the opportunity to organize the related panel discussion and Hugo Nurnberg for the invitation to give the Emanuel Saxe Lecture on this topic and for his comments on the Lecture.

produce drastic changes in the accounting for that transaction such as whether it is on or off the balance sheet) and to present values and/or fair values (exit values).

From his time working as a financial engineer, what he calls his “Bad Bob” years, Herz (2013, p. 14) gives the following examples of accounting-motivated financial engineering:

- “arrangements designed to boost reported earnings by triggering gain recognition on appreciated assets carried at historical cost basis while retaining the underlying risk and rewards of those assets;
- financing techniques involving the issuance of debt-like securities that were treated as equity under the accounting rules;
- financings involving equity securities and hybrid securities that were accorded favorable treatment in computing earnings per share;
- transactions designed to obtain off-balance sheet treatment, for example under lease accounting and rules applying to special purpose entities;
- techniques designed to minimize the dilutive effects of M&A transactions through the use of pooling of interests accounting and other structures that qualified under the accounting rules as common control mergers, joint ventures, and partial combinations; and
- transactions that arbitrated the lack of discounting of future cash flows in accounting for insurance loss reserves and deferred tax assets and liabilities.”

Herz (2013) argues the FASB has made progress in making accounting better reflect the underlying economics of transactions, which is a claim I agree with.

Arguably, the main casualty has been reduced verifiability of accounting measurements (consensus in measurement among disinterested measurers). By limiting the attributes used to evaluate a transaction and using thresholds, accounting traditionally focused attention on the most verifiable features of transactions. When verifiability is reduced, opportunities for measurement manipulation (measurement by self-interested measurers) are typically increased as are information asymmetries about verifiability and manipulability between financial statement preparers and users. When such information asymmetries are large, there is a qualitative change in the nature of the contracting problem between shareholders and managers (Glover, Ijiri, Levine, and Liang, 2005).

Moreover, transactions are endogenous and so can be purposefully designed to be difficult to verify, facilitating even more measurement manipulation. Consider the timely example of lease accounting. If we remove the discontinuities of FAS 13 and instead require firms to recognize the expected discounted value of all lease payments as liabilities, lease contracts may be complicated with contingencies for the sole purpose of making their measurement less verifiable.

## **2.1 Complete versus Incomplete Contract Approach**

The FASB's approach to dealing with financial engineering can be viewed as an attempt to complete contracts. In an initial period, the standard setter chooses a set of attributes and a reporting standard (contract) that describes how those initial attributes are to be mapped into accounting reports. If the standard setter had perfect foresight, she would write a complete contract and choose the initial attribute set to include all future transactions. Of course, the standard setter does not have perfect foresight, and we end up with newly engineered transactions in the second period that have attributes not covered by the existing standard. We then project the current transaction onto the initial set of attributes the standard does cover and accept the corresponding report (by contractual agreement to a rules-based system), even if the new attributes give the preparer a way around the existing standard—to retain the essential economic features of the transaction the preparer desires while also obtaining (the often inconsistent) accounting treatment the preparer desires. The standard setter then revises the existing standard or provides implementation guidance to deal with the newly invented attributes. The standard setter is left (in the dust) trying to complete the contract, with ever more complexity in transactions and the accounting rules for those complex transactions.

The complete contracting approach to standard setting seems predestined to fail. What alternatives are there? In the theory of incomplete contracts, the usual approach is to take the form of the contract incompleteness as given. An alternative is to view the contract completeness itself as a choice variable. The optimal response to an exogenous incompleteness can be to make the contract even more incomplete to allow for non-verifiable information to be incorporated through a subsequent discretionary (non-contractual) response by the principal (Bernheim and Whinston, 1998). In the financial standard setting context, one interpretation of endogenous incomplete contracting is to adopt a principles-based approach—to reduce the attributes specifically addressed and instead increase reliance on judgment. Auditors, the SEC, and the courts would have to play a greater role in evaluating preparer judgments than they currently do. Are the existing institutions up to the job, or is a new institution like Leonard Spacek’s Accounting Court needed?

## **2.2 Normative versus Positive Approach**

A related question is whether the standard setter should adopt a normative or a positive approach to standard setting. The FASB’s approach has been more normative—to come up with its own solutions to financial reporting problems. That is, we have Generally Imposed Accounting Principles rather than Generally Accepted Accounting Principles. Would it be better to look to practice for creative solutions to combat accounting-motivated transactions, with the FASB’s role limited to one of choosing among the best practices that emerge from practice (another way to introduce contract incompleteness)? This was the approach of the Committee on Accounting Procedure (CAP), the standard setter in the U.S. from 1939-1959. While I am reluctant to suggest we return to the approach of yesterday, it is unclear that a normative approach to standard setting is fundamentally superior to a positive one.

To some extent, the FASB was created in 1973 because of the then pervasive view that practice-based standards of the CAP were too permissive and the approach followed by the CAP's successor, the Accounting Principles Board (APB), was too ad-hoc/not based on a conceptual framework. So, it should come as no surprise that the FASB has followed a more normative approach.

Although it is unclear that the FASB's conceptual framework has played a central role in its development of specific standards, characteristics of the conceptual framework are emblematic of general problems with the normative approach to standard setting. Instead of embracing concepts that have stood the test of time such as conservatism and matching, these concepts have been criticized by the FASB. As Littleton observed in the context of lower-of-cost-or-market valuation of inventories, accounting conservatism dates back to at least 1406 (Littleton, 1941). Why has accounting conservatism been such a pervasive and enduring feature of accounting? Is conservatism fundamentally designed to avoid premature payouts (e.g., of dividends or managerial bonuses), to combat managerial optimism, etc.? Does the FASB see these as someone else's problems? More importantly, does the FASB see it as important to understand the role of enduring practices (a positive view), or is the Conceptual Framework to be a normative exercise devoid of context?

Instead of the earlier tradeoff between relevance and reliability, which Herz (2013) continues to use, the current conceptual framework puts relevance above all else as the single objective to be maximized subject to a minimum representational faithfulness constraint (FASB Con. 8, 2010, para QC18). In its deliberations, Board members argued that the concept of reliability is not well enough defined to be useful. My reading of Ijiri (1967) is that this critique is misplaced.

### **2.3 Limitations of FASB Normative Approach**

The FASB has not kept pace with developments in accounting theory. Their focus on decision usefulness is grounded in the work of Trueblood Committee Report (1973), which itself was based on leading accounting theory of that time period. Since then, theoretical work in accounting has moved on. Most uses of financial statements the standard setter labels as decisions are fundamentally strategic. Even shareholders have what can be described as relational contracts with the managers of the firm they own. Shareholder's buy, hold, or sell their shares based on ways managers find to convey their talent, diligence, and trustworthiness. Shareholders act as if they know this is a game. Why else would smooth earnings, meeting analyst forecasts, and a lack of surprises in general be so important to shareholders (Arya, Glover, and Sunder, 1998; Demski, 1998)? A particularly important difference between decision and strategic settings is that more information is not always valuable in strategic settings, which is a result that seems to be ignored by the FASB.

The Wheat Committee Report of 1972 that lead to the formation of the FASB also advocated the FASB involve academia in their work on its conceptual framework. While it is tempting to blame the FASB for largely ignoring this mandate in recent years, accounting academics share the blame. The formation of the FASB can be seen as the point at which standard setters and accounting academics traded places in their normative vs. positive orientations. (Who is the prince and who is the pauper?) Because most researchers now see themselves as social scientists whose job it is to understand and explain (already optimal) practice rather than to change it, it is unclear that they would have much interest in contributing to the development of the conceptual framework or that they see this an activity for which they have a comparative advantage. While there are notable exceptions such as Ohlson et al. (2010),

such contributions are typically viewed as not being important research contributions. Which top universities would tenure a faculty member based on such research?

### **3. Regulation**

Consider three different potential roles of a securities regulator in dealing with financial engineering: (1) targeting bad behavior by individual regulatees, (2) targeting the reporting culture (bad norms), or (3) providing regulatees with incentives to mutually monitor each other. The current approach at the SEC seems most consistent with targeting bad behavior by individual regulatees.

One way to express the financial engineering problem regulators face is: how do we move from a financial engineering culture to a culture of communication and integrity? Preparers seem to see themselves as having to engage in accounting-motivated financial engineering because everybody else does it. Put in game-theoretic terms, there are multiple equilibria, and preparers are playing a bad (from the regulator's point of view) reporting equilibrium. Under this view, the SEC's role is one of upsetting an undesirable equilibrium rather than creating a desirable equilibrium. See Young (2008) for an overview of the approach of viewing a social norm as the play of one of multiple equilibria, which is an idea that was already developed in Hume (1739).

Is it realistic to ask the SEC to change the reporting culture or for any regulator to change any culture? If we take the multiple equilibria view of norms seriously, then why should not the SEC be able to use investigations and penalties to eliminate unwanted equilibria?

#### **3.1 Existing SEC Monitoring Practices**

There are existing practices at the SEC that seem to target, or have the potential to target, a bad financial reporting culture. Examples include the SEC's whistle blower program (which targets a bad reporting culture within a firm) and the Office of Chief Accountant's (OCA's) "pre-clearance" process, whereby preparers seek approval for the accounting treatment of a proposed transaction. A potential desirable feature of pre-clearance is that it can be used by the SEC to get an early warning of emergent troublesome practices before the contagion spreads to other firms and to send a message to the preparer community that a particular practice is one they will object to. The Final Report of the Advisory Committee on Improvements to Financial Reporting (2007) criticized this aspect of the pre-clearance process, instead advocating that the SEC staff emphasize that its pre-clearance process is registrant-specific.

My initial reaction to the pre-clearance process was that it is yet another attempt to complete contracts, which will fail—that the SEC would be better off to leave itself more room for discretion in evaluating reporting behavior ex post, because of the caution preparers would exercise in response. I initially missed the potential of the approach in upsetting multiple equilibria, which is similar in spirit to my own work on "simple" confession mechanisms in single-period settings (for example, Glover, 1994). Whether or not the approach holds up to repeated play is less clear, since preparers could tacitly collude to suppress pre-clearance filings.

Another example is the SEC Division of Enforcement's "wild-cattling." Under Stephen Coutler's direction about a decade ago, the Division of Enforcement began targeting entire industries when there was no ex ante reason to expect there to be a problem with accounting practices in that industry, or there was only a preliminary indication of trouble from the investigation of a single firm. When the investigations occurs sequentially, with a finding of bad reporting at one firm triggering investigations of other firms, wild-cattling has highly desirable

incentive properties in upsetting unwanted equilibria. The fines for firms subject to later investigations are implicitly dependent on the earlier findings at other firms. If the investigations are simultaneous, a desirable penalty structure is a team-based one: each firm's penalty is highest when other firms are also found to be using the bad reporting practice. These (modified) forms of wild-cattling turn the power of investigation up if the reporting norms are bad, while turning the power down when the reporting norms are good. (This thinking builds on the work of Baldenius and Glover (2013) on bonus pools.) From preliminary analysis using a game-theoretic model of the wild-cattling approach under sequential investigations or team-based fines, the expected penalties (and/or probabilities of investigation) needed to upset unwanted equilibria are relatively small when compared to the alternative of treating the preparers independently.

While it may seem a stretch to use team-based fines based on the behavior of multiple firms rather than a single firm, I think this is implicitly done all the time. Sequential investigations of preparers are one example. Another is that the SEC sometimes lets firms off the hook with a warning to change their accounting when many firms in the same industry have all adopted an accounting treatment the SEC objects to. If the SEC is interested in targeting bad norms, then they should instead be tougher on firms when problems are widespread.

Unsurprisingly, preparers object to wild-cattling. The name "wild-cattling" itself conveys the idea of looking for trouble where there is no reason to suspect it, but this complaint leaves out the endogenous correlation that naturally arises under an equilibrium notion of reporting choices. Such investigative policies turn the defense of "everybody-else-does-it" into a regulatory monitoring scheme that discourages bad contagious reporting behavior.

Let us turn to specific disclosure requirements that seem well-suited to improving the reporting culture. Preparers could be asked to report their motivation for transactions that are

fairly wide-spread when the SEC sees them as manipulative, even though they meet the requirements of the particular standard that covers the transaction. For example, the SEC asked preparers to report their motivation for accelerating the vesting of employee stock options just before FAS 123R become effective. Preparers could also be required to disclose the nature of any advice they seek about how the transaction would be accounted for. Financial engineers could be required to register with the SEC their products marketed as having desirable accounting treatments, as well as providing their customer lists to the SEC.

### **3.2 Mutual Monitoring**

An alternative way to support a good reporting culture is to view the FASB and SEC as setting the stage for preparers (or preparers and their financial engineers) to police each other through mutual monitoring and retaliation (“tit-for-tat” play)—a less ambitious role for standard setters and regulators but a decidedly more ambitious role for preparers and financial engineers. When economic agents observe each other’s actions, it can be optimal to tie them together with joint rewards and penalties that motivate them to mutually monitor each other and punish each other for bad behavior (Arya, Fellingham, and Glover, 1997; Che and Yoo, 2001). The mutual monitoring approach turns multiple equilibria into something to be fostered rather than eliminated, since multiple equilibria are a source of implicit contracting among the agents.

For mutual monitoring to work, the SEC has to establish penalties and/or rewards that make preparers or preparers and financial engineers responsible for each other’s bad behavior. This sounds more over-reaching than it is. What is required is that preparers find coordination on good reporting choices more desirable than coordinating on bad reporting choices. A preparer’s temptation to free-ride by choosing the bad choice when other firms are choosing the good choice will be met with retaliation by other preparers. For financial engineers and

preparers, knowing that there will be a joint accountability (e.g., the SEC will be provided with the customer lists of financial engineers) has the potential to make preparers weary of being associated with a financial engineer selling a product designed to get around an accounting standard.

The potential benefits of introducing team incentives are large and could over-turn much of the current thinking in financial reporting regulation. For example, long-term relationships between preparers and financial engineers would be encouraged, as would long-term relationships between preparers and auditors. Instead of fostering collusion (the usual regulatory concern), repeated interaction is used to foster mutual monitoring. The SEC could turn collusion into cooperation by making the right incentive adjustment.

### **3.3 Relative Performance Evaluation**

Relative performance evaluation is potentially dysfunctional when the goal is to target bad reporting norms or motivate mutual monitoring. In other settings, relative performance evaluation is optimal as a corollary to Hölmstrom's (1979) celebrated informativeness condition. By comparing the performance of agents who operate in correlated environments, we can remove common shocks and reduce the cost of providing incentives. Hölmstrom's analysis is one of individual (Nash) rather than group incentives. That is, relative performance evaluation is the answer if the regulator's goal is to target bad reporting by individual preparers (to create a good reporting equilibrium). If instead the regulator's goal is to target bad reporting norms (eliminate bad reporting equilibria) or to set the stage for mutual monitoring, then relative performance evaluation can undermine those goals. For example, relative performance evaluation can make coordinated bad behavior more appealing than coordinated good behavior, undermining incentives for mutual monitoring (Glover and Xue, 2013).

Even when there is no explicit relative performance evaluation, it is often used implicitly (e.g., benchmarking). In regulation too, there are examples of relative performance evaluation. As I discussed earlier, when many preparers make the same mistake, they are sometimes let off with a warning to change their accounting going forward. This can be thought of as a regulatory bailout that encourages coordinated bad behavior—a particularly dangerous form of relative performance evaluation (Arya and Glover, 2005). In other cases, preparers are asked to restate their financial statements with no additional consequences. In announcing such restatements, preparers typically appeal to industry norms as the excuse for their bad behavior (accounting for rent holidays circa 2005 comes to mind).

Under the team incentives approach, a combination of regulatory and self-policing behavior would motivate preparers and financial engineers to behave. A broader point is that various mechanisms (managerial compensation practice, corporate governance, standards, auditing, the SEC's various roles, the courts, mutual monitoring, etc.) interact with each other. To design one without understanding the others is likely to produce dysfunctional results. For example, if the goal of regulation is to promote an environment in which preparers enforce good norms, then detailed guidance by the standard setter would likely get in the way. Guidance reduces the situations in which the choice is left to the preparers, reducing the frequency of future self-governed interactions. This less ambitious role for standard setters and regulators in setting the stage for preparers to mutually monitor each other also seems to have the advantage of creating fewer opportunities for regulatory capture by constituents. See Revsine (1991) for an excellent discussion on regulatory capture in accounting as part of a broader discussion of what he terms “the selective misrepresentation hypothesis.”

In the list of three alternative roles I discussed for the SEC in dealing with financial engineering, I left out an important fourth alternative. The SEC could leave the work of monitoring and punishing bad reporting behavior to others. If it is appealing to have the regulator play a minimal role in setting the stage for mutual monitoring, is it even more desirable to have the SEC play no role in policing bad reporting behavior? Perhaps, private litigation can do a better job than the SEC in setting the stage for mutual monitoring (a version of Hayek's law vs. legislation), although the courts seem to be more constrained by the limited accounting expertise of jurors than the SEC is.

#### **4. Conclusion**

Since financial accounting regulators and standard setters are hard pressed to keep pace with the speed of accounting-motivated financial engineering, it is unclear they should try. In this lecture, I discussed alternative approaches, for example questioning what I see as the FASB's attempts to complete contracts by responding to accounting-motivated financial engineering innovations (which results in increasingly complex accounting guidance and transactions designed to get around that guidance) and the FASB's normative approach to standard setting (vs. the alternative of adopting a more positive approach). I also discussed the role the SEC could have in targeting the financial reporting culture (rather than individual preparer behavior) or, more controversially, in setting the stage for preparers and other regulatees to mutually monitor each other.

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