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Adverse Effects of Accounting, Uniformity on Practice, Education and Research

by

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Professor Shyam Sunder is a world-renowned experimental economist and accounting theorist. His research contributions include financial reporting, dissemination of information in security markets, statistical theory of valuation, and design of electronic markets. He is a pioneer in the fields of experimental finance and experimental macroeconomics.

He has published five books and more than 140 articles in leading journals of accounting, economics, and finance, as well as in popular media. Presently, he is the James L. Frank Professor of Accounting, Economics and Finance at the Yale University School of Management. Before joining the Yale School of Management in 1999, he taught at Carnegie Mellon (Richard M. Cyert Professor of Management & Economics), the University of Minnesota (Honeywell Professor of Accounting), and the University of Chicago.

Prof. Sunder holds a B.S. degree from the Indian Railways Institute of Engineering and a M.S. (1972) and Ph.D. (1974) in Industrial Administration from Carnegie Mellon University.

Among his many other achievements and awards are serving as president of the American Accounting Association (2006-2007); a distinguished international visiting lecturer of the American Accounting Association (2000), and a presidential research lecturer of the association (1999). He also served as the American Accounting Association's director of research (1988 to 1990). Prof. Sunder has twice, in 1982 and 1998, been the winner of the Notable Contributions to Accounting Literature Award of the American Institute of Certified Public Accountants and American Accounting Association. In 1975 he was winner of the Association's best manuscript award.

Abstract

The pursuit of uniform written standards at the expense of social norms diminishes the effectiveness of financial reporting in stewardship and governance, and in better informing security markets. Uniformity discourages thoughtful classroom and discourse, attracts less talent to accounting programs, and ultimately, to the accounting profession. Uniform standards induce a follow-the-rule-book attitude among accountants at the expense of developing their professional judgment. Since judgment and personal responsibility are the hallmarks of a learned profession, the pursuit of uniform written standards weakens the accountants' claim to belong in this class, as well as the claim of accounting degree programs to belong in universities alongside architecture, dentistry, engineering, law, medicine,

and nursing. Uniformity discourages research and debate in academic and practice forums. Most importantly, uniformity encourages increasingly detailed rule-making and shuts the door on learning through experimentation, making it difficult to discover better ways of financial reporting through practice and comparison of alternatives. Improving financial reporting requires creating a careful balance between written standards and unwritten social norms.

Keywords: Accounting standards, uniformity, profession, practice, education, research
JEL Codes: M41, M44

Adverse Effects of Accounting Uniformity on Practice, Education and Research

Samuel Johnson published his dictionary not as the conqueror of the language but as the person who knew best how unconquerable it really is.

Verlyn

Klinkenborg (2005)

The rules of accounting, even more than those of law, are the product of experience rather than logic.

George O.

May (1943)

Common global standards, if read to mean identical, is an illusory and unobtainable goal. However, seeking to achieve similar objectives and to address in an effective way similar problems is a realistic goal.

Richard Breeden (1992),

Former Chair, SEC

I am delighted to join you this afternoon to engage in a conversation about the attempts to achieve uniformity in accounting practice through authoritative standards and the effects this pursuit has had on practice, education, and research. It is a special pleasure to do so in a lecture series in memory of Emanuel Saxe, who contributed so much to accounting education and worked to build Baruch College into a center of excellence in accounting education. The list of lecturers who have preceded me at this podium is a who's who of accounting thought and scholarship. Indeed, I have often read, and had my students read, many of the lectures delivered here. I feel honored to join their ranks.

The pursuit of uniformity in accounting practice through standards and their enforcement by authority has been a dominant phenomenon in accounting during the past half-century. In the recent decade, the convergence of accounting standards and the harmonization of accounting practice have been the policy of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). If the current trends continue, the United States, the European Union, and many other parts of the world may claim to have reached this long-sought goal of uniformity in the foreseeable future.

This pursuit of uniform financial reporting through official enforcement of standards written by organized boards enjoys broad support from government, business, the accounting profession, and academia. It is widely believed that uniform standards will result in improved financial reporting, better governance and stewardship of business, not-for-profit, and governmental organizations, and better informed and therefore more efficient financial markets, which will direct capital towards its productive deployment.

In this hour, I shall make a contrarian case: Pursuit of the goal of uniformity diminishes the effectiveness of financial reporting in stewardship and governance, and in better informing security markets. Uniformity discourages thoughtful classroom discourse, and thereby attracts less talent to

accounting programs, and ultimately, to the accounting profession. Uniform standards induce a follow-the-rule-book attitude among accountants at the expense of developing their professional judgment. Since judgment and personal responsibility are the hallmarks of a learned profession, the pursuit of uniform written standards weaken the accountants' claim to belong in this class, as well as the claim of accounting degree programs to belong in universities alongside architecture, dentistry, engineering, law, medicine, and nursing. Uniformity discourages research and debate in academic and practice forums. Most importantly, uniformity encourages increasingly detailed rule-making and shuts the door on learning through experimentation, making it difficult to discover better ways of financial reporting through practice and comparison of alternatives.

The enthusiasm for the pursuit for uniformity should be tempered by recognition of these unintended consequences of the path accounting has chosen to take. Perhaps it is not too late to adjust our goals so we can achieve better financial reporting by balancing written standards. I shall organize my remarks on theory, practice, education, research, and the structure of accounting institutions before turning to reforms that might be considered as candidates to the pave the way for better financial reporting.

1. Uniformity and Classification

Uniformity has long been the holy grail of rule-making in accounting. The diversity of accounting practices invites criticism. It is an intuitively appealing idea that if the accountants would treat similar transactions similarity and different transactions differently, financial statements would be more useful. Unfortunately, it is not true.

The problem is no two events, or transactions are exactly identical, nor are they totally different. Close examination reveals some similarities as well as some differences between any two transactions.

Transactions come in infinite variety, and the accountant must classify and aggregate them into a manageably small number of categories. We can use one of two principles to classify any set of transactions into a small number of categories:

1. Treat any two transactions that have any differences differently
2. Treat any two transactions that have any similarities similarly

By choosing one of these two principles, we must necessarily violate the other. This gives rise to a fundamental problem in defining and attaining uniformity and comparability in financial statements.

When applying the first criterion, each transaction being different from all others in *some* respect, will be treated differently. This will yield an unmanageably thick accounting rule book, and each rule will be used only once. In effect, there will be no categorization and no aggregation. Some may call this a system without rules and uniformity because no two transactions are treated alike. Others can, with equal justification, refer to the system as the ultimate in uniformity, in the sense that two transactions must be exactly identical in order to qualify for the same treatment. The pursuance of uniformity carried far enough leads to complete diversity.

Paradoxically, applying the second criterion does not improve things. If any two transactions that have anything in common between them must be treated alike, then all transactions will end up in a few, or even a single, category. In accounting, this is not of much use either. This problem is common to all systems of rules and laws, as well as to other schemes of classification.

The point can be graphically illustrated by a simple example of four objects which differ in, say, size and color—two large, two small, two black and two white (see [Panel A](#) of Figure 1). Applying the first uniformity criterion to size (objects with any differences should be treated different), we get the classification shown in [Panel B](#). However this classification would leave those who consider color to be the important criterion dissatisfied. Applying the first uniformity criterion to color, we get the

classification shown in [Panel C](#), which would leave people who consider size important unhappy. It would seem that there is a simple solution: apply the first criterion to both size and color, and we get the classification shown in [Panel D](#).

However, D is far from perfect when we look at the second criterion of treating similar transactions alike. This four-way classification also leaves people wondering why two objects which are both black are being treated differently, and why two objects which are both large are being treated differently. In short there is no conceptual way, even in a simplest theoretical example, of satisfying the uniformity criterion in a world in which more than one attribute of transactions are important to the users of financial statements. In practice, things get even more complicated.

The accounting treatment of research and development (R & D) outlays is a case in point. Until the FASB issued Statement No. 2 in 1974, capitalization of these outlays was left largely to the discretion of management. Practices varied across firms. Demands for uniformity led the FASB to search for rules that would reduce management discretion in capitalization decisions and closely approximate the economic nature of these events.

The FAS No. 2 removed managers' discretion by requiring that these outlays be expensed. It achieved uniformity of form, but not substance. The underlying event that is supposed to be recorded is not the R & D expenditure alone, but also its economic consequences. Compulsory expensing of R & D outlays, irrespective of its results, creates a greater divergence between the underlying event and its accounting treatment that might occur under a discretionary system. Two firms, each having spent \$10 million on research, will have identical financial statements, irrespective of the development of a hot-selling product by one of the firms. Whether FAS Statement No. 2 has led to greater uniformity of financial statements in this fundamental sense is open to question.

Let me summarize my first main point: There is no conceptual way of defining the uniformity criterion so it can help guide standard setters, preparers or auditors to improve financial reporting. Concepts such as uniformity and comparability are operationally vacuous for accountants' work.

2. Uniform Standards vs. Social Norms

Norms of a social group can be defined as the common knowledge expectation of its members about how others behave in various circumstances. (1) Wearing a coat and tie in an office is its social norm if, even in the absence of any formal rules and enforcement process, and in the presence of available and convenient alternatives, people do in fact wear a coat and tie and expect others to do the same. In this sense, social norms or conventions are indistinguishable from the culture of the group (Sunder, 2002c).

Unlike formal rules and regulations, motivation to conform to social norms is rooted in the anticipation, or even fear, of others' disapproval of deviations for the norms. Social norms may be so internalized by individuals that conformity may be seen as a moral or ethical obligation. When norms become sufficiently internalized, the members of the group may find it unnecessary to monitor conformity, giving rise to trust. The key mechanisms that create trust in society are personal relationships and social embeddedness of market participants rather than the legal rules and the formal enforcement structures.

It has been so long since accountants began to shift their allegiance and attention away from norms that the authoritative promulgation of accounting practices is often assumed to be synonymous with the progress or advancement of accounting. It is easy to identify the history of accounting principles with organized efforts to produce written rules because documentary traces of such processes are more easily available for the historians; social norms, even if they are widely accepted, leave nary a footprint in the public record. We can see the evidence of norms in fiction (2), (3). Unfortunately, accounting is hardly a favorite subject in English or other literature.

Yet the early predominance of norms is clear from the charge the American Association of Public

Accountants gave to a Special Committee on Accounting Terminology in April 1909 "to collate and arrange accounting words and phrases and show in connection with each the varying usages to which they are put.... This committee will not attempt to determine the correct or even the preferable usage where more than one is in existence." (Zeff 1971, p. 112).

In 1918, a reprint of a memorandum on auditing procedures, prepared by the American Institute of Accountants, and approved by the Federal Trade Commission (FTC), and originally published in the *Federal Reserve Bulletin*, was labeled "A Tentative Proposal Submitted by the Federal Reserve Board for the Consideration of Banks, Bankers, and Banking Associations; Merchants, Manufacturers, and Associations of Manufacturers; Auditors, Accountants, and Associations of Accountants." The intent was to coordinate the evolution of a norm and not to impose a standard.

In the same year, the American Institute of Accountants appointed a Special Committee on Interest in Relations to Cost to address a lively controversy on imputed interest as part of the cost of production. The Committee's recommendation against inclusion of imputed interest in cost of production, and its approval at the annual meeting of the Institute, did not become accepted as an accounting norm.

The absence of authoritative standards of accounting did not mean that the world of accounting had less order in the early twentieth century than in the early twenty-first. Zeff discusses several active mechanisms the accountants of that era might have used to identify the norms of their profession. The pages of the *Journal of Accountancy* and perhaps *CPA Journal* served as forums for active, even feisty debates on accounting and auditing; a function largely abandoned by the accounting journals over the past quarter century as authoritative standards pushed the norms out. During 1920-29, the Librarian of the Institute issued 33 "special bulletins" on topics referred to them, albeit without the authority of the Institute. In 1931 the Institute published a 126-page book, *Accounting Terminology*, a compilation of accounting terms and their definitions as a matter of advice, not authority. (4)

The stock market crash of 1929, and the economic depression that followed, also precipitated another crash—in the trust in norms of accounting and the formal or informal mechanisms by which these norms evolved and were sustained. The social contract was broken. In response to adverse events, politicians introduced securities laws and regulations to replace the norms and private innovation in response to adverse events. (5) In the following seven decades, accounting and auditing failures were interpreted as evidence that norms do not work; norms were gradually shifted to the back burner, and FASB (or SEC) mandated standards rose to dominate accounting.

The shift is also reflected in the increasingly assertive nomenclature of the three private sector organizations that wrote accounting rules and how they labeled their publications: The Committee on Accounting Procedure's Accounting Research Bulletins (1939-59), the Accounting Principles Board's Opinions (1959-73), and the FASB's Financial Accounting Standards (1973-present). The IASB's International Financial Reporting Standards are the latest addition to this trend. Have the standards achieved, and can they achieve, their purported goal?

3. Practice

As a matter of practice, consider four reasons why attempts to create a uniform set of top down written standards does not necessarily dominate social norms in financial reporting. I labeled them as the (1) information, (2) design, (3) gaming and (4) signaling problems.

3.1 The Information Problem

Rule makers face a difficult problem in identifying good rules. This difficulty may be seen by asking even a simple question, like what is a good rule for determining interference in a game of football? Rules can affect different members of society in diverse ways. The direct effect of the rules on people depends on their individual circumstances, which the rule maker knows little about. Rules are designed

in the hope that they will change or constrain the behavior of at least some people. However, changes in individual behavior interact in complex ways, which can generate aggregate consequences that are difficult to anticipate. The rule maker may try to ameliorate this informational disadvantage by soliciting information from the parties potentially affected by its actions. Unfortunately, these parties have little incentive to report truthfully. Their strategic responses only muddy the waters (see Sunder, 1997, Chapter 11, and Sunder, 2003), and create the gaming problem discussed below, often forcing the rule maker to deal with unintended consequences of the rules. Evolved social norms often incorporate more information than the rules made by legislatures, boards, and other government regulatory bodies.

3.2 The Design Problem

The corporate entities for setting standards need structure, people and resources. All three requirements force compromises in the design of the entity. Legislative structures emphasize representativeness; judicial structures emphasize impartiality, while bureaucratic structures value rules of procedure above all. It is not possible to attain representativeness, impartiality, and consistency of procedures all at once.

Finding people to operate the rule-making system raises parallel problems. The best experts may not be representative or impartial, and they may be inclined to use their judgment instead of following pre-defined procedures. Representative bodies may lack expertise in the substance of the matter, and may not place impartiality high on their agenda, and so on. Finally, those who pay for the cost of developing uniform standards understandably seek to further their own agenda through their influence over the finances of the standard-setting entity. Such inevitable compromises distort the functioning of standard-setting bodies.

In contrast, the gradual evolution of social conventions is less susceptible to these weaknesses of corporate entities because such entities do not play a major role in the process.

3.3 The Gaming Problem

The difficulty posed by the information problem discussed above is compounded by the dynamics between rules and the behavior that the rules are intended to influence. Each standard alters the decision environments of the relevant individuals and, at least alters their decisions. Standards also induce individuals to search for new alternatives, or create opportunities that may not have existed earlier. The rule makers, with limited information, cannot anticipate all such change, and the rules often lead to unintended consequences in the form of individual behavior and their social outcomes. (For example, Tan and Jamal (2003) found that reducing discretion in accounting rules has an unintended effect of changing the "real" operating decisions of managers.) Any adjustment of the rules to such outcomes sets up yet another cycle of adjustments and changes. Individuals can adjust faster than the rule makers can. It is difficult to make sure that this action-reaction sequence converges to a rule and pattern of behavior, which are in mutual equilibrium, and that this equilibrium is Pareto superior to the status quo (i.e., does not make anyone worse off).

3.4 The Signaling Problem

A uniform standards approach to financial reporting favors narrowing the range of options available to the reporting entity and foregoes a valuable signaling opportunity. Many believe that a narrower set of choices available to the accounting entity in how to report a given event or transaction promotes comparability and consistency and enhances the value of financial statements. This argument ignores the signaling value of the choices made by the reporting entity. In making a choice from a given set of alternatives, the entity cannot help but reveal information it holds privately about its preferences and expectations. Managers of the entity reveal their privately held information, in part, through the financial reporting methods they choose (Dye, 1985) and (Levine, 1996). The use of aggressive reporting methods gives valuable information to careful readers of the financial reports. Narrowing

financial reporting choices through uniform standards also eliminates the ability of managers to transmit information through their choice of financial reporting methods. This signaling aspect of financial reporting has received little attention in the setting of accounting standards.

Under social norms a broader range of behavior remains permissible and acceptable. The more tightly specified the school dress code, the less one can learn about individual children from their appearance in the playground; without choice and self expression, less information is available to others. Morison (1970, p. 281) wrote:

The power of free and rational argument remains, I am old-fashioned enough to believe, the best road to the truth in human affairs. I would therefore give companies the maximum freedom to present their accounts in whatever way they thought fit, and would then require them to explain and justify the course they had taken. The auditor's task —no light one!— would be to ensure that they did. And to see they did it fairly.

I would not go so far and give companies "the maximum freedom"; but allowing them a choice among a small set of carefully chosen competing standards would be helpful. The information, design, gaming and signaling problems are ever-present in setting standards; they deserve consideration when we weigh the roles of uniform standards and norms in financial reporting.

4. Law and Social Norms

Legal scholarship and practice is careful in recognizing the limits of the efficacy of written rules. When it is not possible to write a rule that will improve the state of affairs compared to a judgment-based system, the law leaves the judgment in place, irrespective of the importance of the question at hand. When a judge asks the jury to determine if the accused is guilty beyond reasonable doubt, lay jurors would want to know how much doubt is reasonable: ten percent, two percent, or one percent? Law does not attempt to codify answers to such questions. Legislators and lawyers understand all too well the consequences of clarifying such questions can be even less desirable than the consequences of leaving the answers to judgment, even when the judgment is to be exercised by laymen. Similarly, the Securities and Exchange Commission and the U. S. Congress refuse to clarify the definition of insider trading beyond "trading on non-public information." Again, the consequences of clarifications are even less desirable than the consequences of leaving such matters to ex post judgment.

Accountants, on the other hand, have been willing to pursue uniformity through endless clarification of accounting rules to the point of defining the percentage thresholds of materiality, lease capitalization, consolidation, and non-consolidation of special purpose entities, etc. With such written standards in place it is child's play for the Wall Street bankers, accountants and lawyers to design transactions to frustrate the intent of the standards, no matter how carefully they have been drafted. Setting up accounting institutions whose sole function is to issue new accounting rules, has contributed to the tendency to write standards which are "generally accepted" only in the sense of "follow them, or else...." Accountants could borrow some wisdom from law, remove the monopoly jurisdictions of rule-makers, and introduce elements of competition among rule makers within each financial reporting jurisdiction in order to avoid this problem (Dye & Sunder, 2001; Sunder, 2002a and 2002b).

5. Accounting Institutions

Written standards with formal enforcement are concrete and salient. Standards are published, easily disseminated, specified formally with some precision, and can be cited, analyzed and discussed line and verse. (6) They come into existence at a specific time, through a known and understood institutional process that may allow the participation of the constituents. When the environment changes or the standards are no longer perceived to induce the desired patterns of behavior, a systemic process is available to formulate changes and submit them to a well-specified process for possible promulgation.

A transparent institutional mechanism for setting and modifying standards holds a natural appeal in a democratic polity. Following accidents and scandals, "the rules were not clear," is a popular defense for scoundrels and managers who have not adopted good data handling practices. Codification of standards - let us make the rules clear to all—is a frequently chosen response to calm the political waters. (7) Formal written standards also appeal to our sense of good housekeeping.

Social conventions and norms are less well defined, vary in time and space, and require an extended socialization process to learn and understand (Coleman, 1990). Conventions carry a penumbra of uncertainty about the edges; there is substantial but incomplete overlap among the beliefs of the individual members of a group about its norms. Even with a unique definition in time or place, norms evolve in small, almost imperceptible steps, by processes that are neither observable nor well understood. The evolution of norms is decentralized in the extreme, and even experts find it difficult to know which rules or practices are better, and to predict their future direction. While the evolutionary process is not opaque, the lack of definition and our poor understanding of how norms evolve make them less transparent. Scandals and crises, when they occur, mock the claims of expertise and efficiency required to legitimize existing institutions. It is hardly surprising, then, that during periods of crisis, political or bureaucratic decision makers feel pressure to displace market and social processes and write new standards instead of relying on existing (recently discredited) norms and business practices.

There is also a fundamental weakness in the structure of a standard-setting body. A permanent rule-making bureaucracy must continue making rules in order to justify its ongoing budget and existence. If their sole job is to make rules, should we not expect that they will create more rules and inevitably, the rulebook will get thicker over time? Until recently, the FASB was dependent on the sale of its publications for a significant part of its revenue. The rule of "publish or perish" is as true in this situation as it is in academia.

Another consequence of having institutions with rule making as their sole function is that their existence encourages requests for "clarifications." Auditors are asked to produce a rule to back up their judgment calls, especially when their judgment is to a client's disadvantage. If the FASB/IASB does not respond to a call for rule clarification in a timely fashion, it can become the basis for a client to have his way. Absent the rule-making agency, auditors would have to worry about the fair representation requirement under the security laws. In this way, the existence of standards boards promotes an attitude of, "if it is not prohibited, it must be OK." Investment bankers frequently play a game of hide-and seek: they call the FASB/IASB for rule clarification and then do some financial engineering to get around the rules. While a reasonable body of rules might be devised to deal with a given set of transactions, it is impossible to devise a system of rules when transactions are continually being redesigned to get around them and to frustrate the intent behind the rules.

6. Education and Research

While the attempts to write uniform standards of financial reporting are primarily driven by their direct and immediate impact on capital markets, they also have major educational consequences. It is possible to argue that these consequences may well be equally if not more important, and the certainly deserve more attention from academics. Moreover, those charged with the responsibility to develop uniform standards should include the educational consequences of their actions in a part of their deliberations.

The expansion of the ambit of written authoritative standards has led to fundamental changes in textbooks, course content, classroom discourse and examinations, including professional examination for CPA certification conducted by the AICPA. In the absence of an authoritative standard for a class of transactions; textbooks, class discussion, and examinations are designed to explore various possible ways in which a transaction could be accounted for, consequences of alternative accounting treatments for various parties, and the economy as a whole. Such discourse develops the mind of students to think fundamentally, does not allow for black and white answers, and helps attract young people with powers of abstraction to the accounting profession. Exercise of judgment, after all, is a hallmark of a profession.

With expansion in the scope of authoritative standards, educational discourse has progressively shifted toward rote memorization of written rules to be regurgitated in the examinations. With the accounting standards written by the FASB being granted a monopoly status for public companies, intermediate accounting classes have moved towards focusing on line and verse application of those standards, and not on critical examination of the merits of alternative accounting treatments for various classes of transactions. Such "memory-based" curriculum tends not to continue to attract talented youth to a profession for long.

A second aspect of the problem is the educational capacity. Under the current system just discussed, college and university courses in the United States spend a great deal of time and course work teaching the specifics of accounting standards. It has been argued that competition among multiplicity of standards would call for even more accounting courses, core requirements, faculty, classrooms and other academic resources, and tuition fees or taxes to pay for them all. Under the current system of accounting education, it is not reasonable to expect the students, who have been drilled to memorize the specifics of FAS to figure out by reading IFRS what they are supposed to do or not do. While accounting firms worry about additional costs of multiple standards and seek to save them by arguing for uniformity, some in academia see this as an opportunity for expanding accounting programs.

Alternatively, we could consider moving the accounting educational system towards the direction of teaching general principles which are largely independent of the specifics of the standards issued by one or another regulator from time to time. Students educated in such a higher level system of education will have developed the powers of abstraction that would allow them to pick up any system of standards and apply them to specific transactions using their own judgment derived from education in general principles. Even under this alternative, given that the intermediate accounting courses and textbooks have already become predominantly oriented to rote memorization of standards, time and resources would be needed to reorient the accounting education system.

Juliet Cao of the University of Washington at Tacoma writes (8):

In short, I realize that it will be really useful if the students can walk away from the classroom, knowing (1) what exists is not necessarily optimal (e.g., FASB setting everything for us); (2) what is hard to achieve is not necessarily undoable (e.g., introducing competition into standard setting); (3) that it is ultimately us, individual accounting professionals, that shape the whole industry. It is sometimes a pity that students are drowned in technical details most of the time and instructors do not have enough time to expose them to more interesting (and important!) aspects of accounting. This especially true for intermediate accounting, as most students may plan to take the CPA exam and feel uneasy when the instructor diverts from the specific topics that "should be covered" because they will show up in the CPA exam.

Reliance of financial reporting on uniform written standards and their convergence in the United States and the world does not hold promise of a place for accounting in university education. Such reliance does not help attract people who are willing to think, develop and use their judgment and take personal responsibility and rewards that go to the professionals who are willing to do so. Instead, accounting appears to be headed for the low road, and we should not be surprised if the better students in business schools shun accounting after the Sarbanes - Oxley-induced bubble in demand for accountants subsides, as it inevitably will.

7. Concluding Remarks

Finding a balance between uniform standards and norms, and defining the extent of their respective roles in financial reporting, are not easy tasks. Standard-setters find it difficult to know which standards are superior, and what should be the criteria for ranking the alternative standards. Societies that depend

on norms and tradition also can get stuck in efficient solutions (e.g., slavery) and it may take reform movements, even armed uprising, to release them.

By their very nature, evolved social norms (and culture) are specific to the society they serve. Variations in evolved systems, like in the beaks of the finches inhabiting various valleys of the Galapagos Islands, or in wedding ceremonies in various parts of the world, are not explainable entirely in terms of identifiable factors. Random chance and history also play a role. Attempts to harmonize financial reporting across the world assume that all cross-country variation in financial reporting practices is random or at least that the advantages of dispensing with such variations exceed any reduction in the fit between the local economic environments and the financial reports. The practices proposed for universal use are those prevalent in the English-speaking countries, especially the United States and the United Kingdom. Such ethnocentricity would be rejected in most other social sciences but it remains largely unchallenged in financial reporting.

The monopolies in the United States and the European Union deprive the economies and rule makers of the benefits of experimenting with alternatives. Under a monopoly regime, one can no longer observe what happens if an alternative method were used. If the whole world uses a single method of accounting that happens to be flawed, it would be almost impossible to produce convincing observational evidence that there is a better method. Discovering efficient rules of accounting is a difficult problem because of the lack of reliable information about the consequences of alternatives. A monopoly restricts the amount of information available to the rule makers as well. Why should we deny ourselves the benefit of information from competitive markets? This preference for uniformity stands in the way of the evolution of accounting, denying accountants the right to develop new and better methods.

The pendulum appears to have swung too far in the direction of uniform standards. We should reconsider giving social norms a stronger role and restoring personal and professional responsibility in business. Without a need for responsibility and careful reasoning, the accounting profession itself will be diminished.

We should again take up the social norm of "fair representation" as a moral compass for accounting just as "guilty beyond a reasonable doubt" is used in criminal law. Written standards cannot capture either of these ideas. It may be necessary to create some kind of accounting court system to judge what constitutes "fair representation," as Leonard Spacek (1958) proposed long ago.

We should assist the evolution of accounting norms by allowing competition among multiple accounting rule makers with no collusion or push for convergence. Instead of being forced to use the FASB's standards, what if United States firms could choose to use FASB, IFRS, or another standard system? Standard-setting bodies could then receive their income solely from royalties charged for the use of their standards and have their revenue based on how well their system actually works, not on how many rules they write. With competitive standards, we will have a healthier system of discovering better accounting systems and developing them over time, without eliminating judgment, and creating a better balance between standardization and norms.

Is it possible to tame the financial reporting practices of corporations through substantial, if not exclusive, reliance on uniform written rules and punishment for violations? While the standard setters erect short sections of fence in the vicinity where the lion was last spotted, the compensation committees of the boards throw red meat of juicy compensation packages, encouraging hungry animals to walk around these flimsy barriers in the open jungle of financial reporting. A body of evidence on behavior of social animals suggests that beyond their physical needs, constraints and threats, norms of their own society play a significant role in what they do. Perhaps it is not unreasonable to think that, given the importance of our own extensive and complex social structures and norms in various walks of life, ignoring them in financial reporting may not be a wise course.

In the preface to his *Dictionary*, Johnson wrote about his "fortuitous and unguided excursions into...the

boundless chaos of living speech." Can authoritative uniform standards without collaboration with social norms bring a semblance of order to the chaos of financial reporting? After seven decades of incessant efforts, the answer stares us in the face.

Footnotes

(1) Common knowledge of X, in its technical meaning, is shared knowledge among two or more people so each knows X, knows that others know X, knows that everyone else knows X, ad infinitum.

(2) For examples of accounting and commerce in Chaucer and Goethe and other German literature, see Russell (1986), Gallhofer and Haslan (1991) Jackson (1992), Ganim (1996), Maltby (1997), Parker (1999), and Evans (2005).

(3) Waymire (personal communication) suggests that researchers have rarely ventured to examine the internal correspondence and discussions of client and audit firms where they might find the "footprints" of social norms.

(4) In his review of *Costing Terminology*, Kitchen (1954) provides a masterful argument for resisting the temptation to issue official definitions, especially in accounting. See also Baxter (1953).

(5) Also see Jamal et al's (2005) finding on the evolution of the U.S. web seal market to provide assurance on privacy practices in e-commerce. Under the stricter regulatory regime of the European Union, no such market has developed.

(6) See Fuller (1964) and Dworkin (1986) for discussion of natural law theory, and Hechter & Opp (2001) for an overview of the sociology of norms.

(7) In response to William Z. Ripley's *Atlantic Monthly* (September 1926) article, "Stop, Look, Listen!" accusing large corporations of dishonest and deceptive financial reporting practices, even George O. May said: "...it seems to me that the extension of the independent audit, accompanied by a clearer definition of the authority and responsibility of auditors, is one of the most valuable remedies to be found for the defects of which Professor Ripley complains..." May was an influential leader of the U.S. accounting profession and seemed to favor norms over standards.

(8) Personal correspondence.

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**Figure 1 Panel A: Four Objects with Two Properties (Size and Color)
(Two Large, Two Small, Two Black, Two White)**

([Panel A](#))

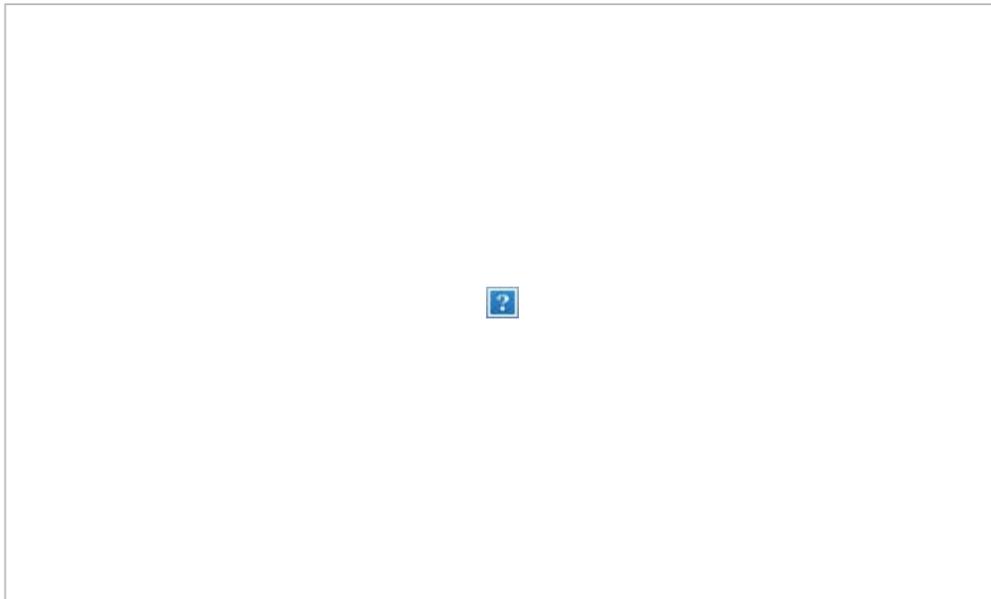


Figure 1 Panel B: Classification of Four Objects by Size (Two Classes)

([Panel B](#))

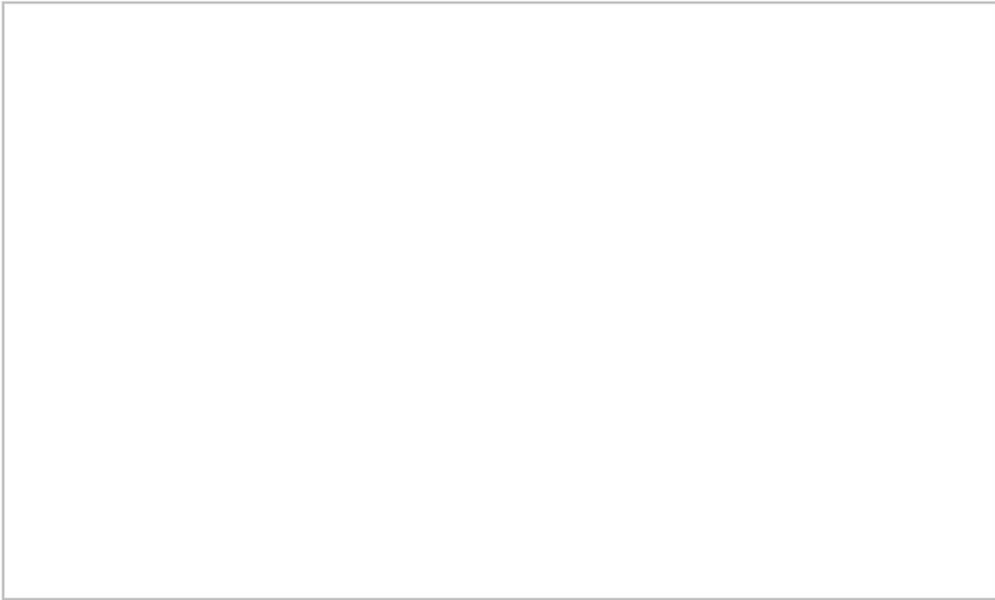


Figure 1 Panel C: Classification of Four Objects by Color

([Panel C](#))

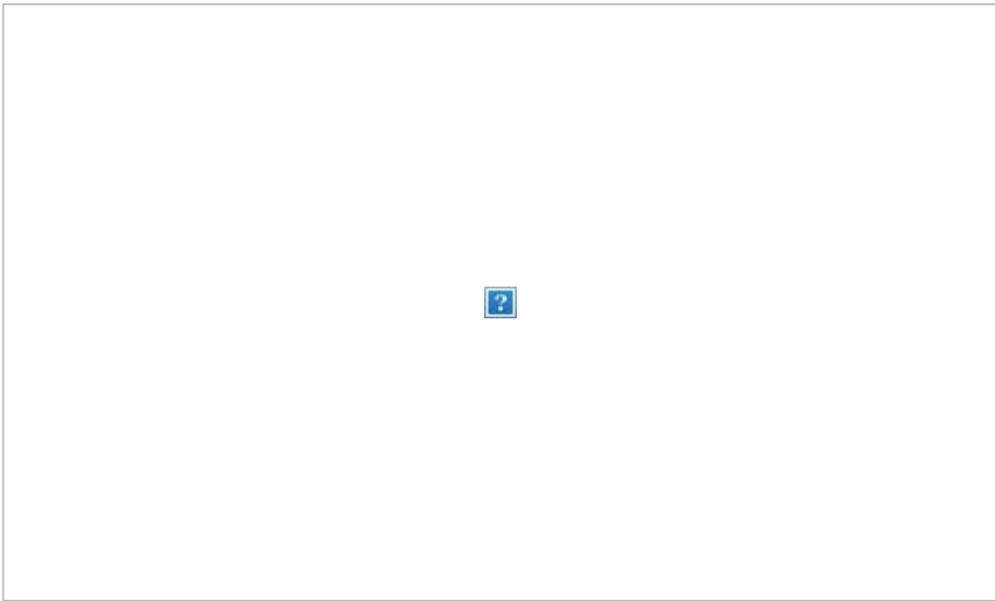


Figure 1 Panel D: Classification of Four Objects by Size *and* Color

([Panel D](#))

