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Uniform Financial Reporting Standards
Reconsidering the Top-Down Push

By Shyam Sunder

MARCH 2007 - Arguments for developing and enforcing uniform international standards for financial reporting have been eloquently articulated elsewhere, and I shall not repeat them at length here. The European Union and many other countries are on their way to adopting, implementing, and enforcing the International Financial Reporting Standards (IFRS). Indeed, the question today is not the *desirability* of uniform worldwide standards, but *how* we might implement them.

The core arguments for uniform standards are as follows:

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

Although these are valid arguments, to provide a more balanced perspective on which to base public policy, we should examine both sides of the issue.
The benefits of uniform standards are clear, concrete, and immediate. The arguments on the other side are diffuse, hypothetical, and their consequences lie mostly in the future. It is easy to ignore the hypothetical in favor of the concrete. Many would concede, however, that hypothetical opportunity costs are often a better basis for making decisions than concrete historical costs.

Consider a system of supervised competition among multiple sets of standards written by independent bodies such as the IASB, FASB, or accounting firms. Investors, companies, and auditors could then choose from a set of competing standards. It is possible, through market competition, for one set of standards to win out over the others, or for several sets to coexist, each attracting its own clientele without government enforcement. This bottom-up alternative to "standards monopoly" offers several advantages.

The Language of Business

Accounting is the language of business. As with any other language, it derives its vibrancy from the changing dynamic of the meanings of words. The value of the Oxford English Dictionary arises from the encyclopedic collection of the various ways in which a word may be used, not in recommending or enforcing its opinion. The power of the English language derives, not from authority, but from the freedom with which it permits us to communicate. Many natural languages have been, and some continue to be, strangled by the over-jealous advocates of their purity, determined to force uniformity of usage. No language, including accounting, can flourish under the protective umbrella of punitive authoritative regulations.

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

As an alternative to this command-and-control perspective, consider a Darwinian world where complex phenomena emerge through unpredictable events and their poorly understood interactions. Information in our economy is inherently dispersed. It is impossible for any centralized authority—no matter how wise and benign its intent—to possess the necessary knowledge to design social systems to effectively address all possible issues.

By trying to standardize accounting from the top, using command-and-control, the accounting profession seems to have learned nothing from the mistakes of central planning. Must we lose another hundred years in making mistakes we can call our own, before we learn?

The design of social systems is far more complex than that of physical systems because the elements of social design—human beings—react to the choices and adjust their behavior. People affected by standards take little time to adjust their behavior and redesign their transactions to get around the intent of the slow-moving standards setters. This dynamic game between economic agents and standards setters is a losing battle for the latter.

Written standards have been of great value in certain systems, such as computer operating systems and Internet protocol. Yet, absent competition between Apple and IBM PCs, we might still be running the Microsoft DOS of the early 1980s.

Information has interesting qualities. Standards setters may think they can improve the usefulness of financial statements by reducing the number of permissible accounting alternatives. But the choices we make reveal our secrets. A company that chooses the accelerated over the straight-line method of depreciation reveals the higher degree of confidence its managers have in the future of the company. How else could it credibly reveal such information to investors? The uniformity dogma in financial reporting ignores the signaling value of the choices people make.

The standards have shifted the focus of accounting education from preparing professionals to think about the best way to deal with any given event or transaction, to telling professionals what the rulebook says. Can we attract talented youth to study a discipline that consists largely of memorizing a fixed set of rules? When written standards define financial reporting, professional judgment is discounted and replaced with a "cover your assets" mentality. When we consider the effect of standards on the attitudes of corporate managers and auditors, standardization runs counter to making difficult judgments after considering the relevant facts. Standards provide a cover from having to take personal responsibility for one's judgments. The scandals of recent years have made it clear that, after 30 years of intensive pursuit of the "gold standard" for accounting, we have discovered fool's gold.

Over the past seven decades, standards have progressively become roadmaps for evasion. It has been suggested that standards should be based on principles, not rules. However, "rules versus principles" is a misleading debate. No standards setter sets out with a preference for rules over principles. The standards setters' monopoly existence with their sole duty to develop standards forces them to "clarify" their principles, and that ultimately degenerates into rulemaking. Financial accounting standards are more detailed only because FASB has had more time and a larger budget. Twenty years from now, the IASB's rulebook will probably be just as voluminous. Its processes are similar, and so will be the outcomes.

The Essence of a Learned Profession

Few aspects of our lives exclude social norms and depend so exclusively on written standards to the degree being attempted by accountants. No other learned profession relies on standards as accountants are being asked to do. Not doctors, not lawyers, not dentists, not actuaries. Judgment, not a written standard, is the essence of a learned profession. If we do not stop chasing the mirage of uniformity and comparability now, we may soon destroy our profession and any value society places on its services.

Even people who agree with these arguments may ask: What do we do? Isn't it too late to stop the speeding train of standardization of financial reporting? As to the first question, I do not suggest a free-for-all in accounting. Some experts in the field have argued, not against standards and definitions, but merely against those written by authority. I suggest moderating the power of the SEC that stands behind FASB and the PCAOB, and the power of the European Union and the increasing number of other governments that stand behind the IASB.

In each jurisdiction, the appropriate authority could choose at least two, perhaps three or four, bodies whose standards would be acceptable. Every company in that jurisdiction would be allowed to choose the set of standards it wishes to follow. These bodies would be financed exclusively by the royalties they collect from the firms that use their standards.

The standards setters would effectively compete with each other for these royalty fees, and would be forced to make difficult choices which might possibly reduce the cost of capital of the companies that use their standards.

Convergence may or may not emerge from this bottom-up competition. Such competition occurs in many regulated fields, including stock exchanges, bond raters, and university accreditation. There is no evidence that competition would reduce quality.

Is it too late to try to stop the speeding train of standardization for financial accounting? Not if we are convinced that reversing policy is in our best interest.
In the true spirit of open debate on matters of public policy, I realize that many readers may strongly incline toward the pro-standardization case we have heard over recent decades from the distinguished proponents of uniform, enforced standards. I request only that you withhold judgment until we have developed, heard, and weighed both sides of the argument on both sides of the Atlantic.

Lest these remarks be regarded as an attack on IFRS, Statements of Financial Accounting Standards, or their creators, allow me to quote from the late Professor William T. Baxter of the London School of Economics:

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

Those words, from his article "Recommendations on Accounting Theory," were published in *The Accountant* in October 1953. Perhaps it is time the debate begins.

Why Reconsider?

- Uncertainty and the dynamic, cross-sectional variation in meanings attached to words are the essence of any language; the same is true of accounting.
- There are disadvantages to a Cartesian top-down design, command-and-control, central planning perspective when compared to a Darwinian-Hayekian evolution [Ed.: named for Friedrich Hayek, a renowned 20th-century economist and political philosopher], and an emergence from markets and a social processes perspective.
- Standards setters will always be too slow to respond effectively to evasive maneuvers of unscrupulous companies.
- Uniformity dogma ignores signaling the value of choice.
- The degradation of accounting education and training, and the unattractiveness of such a profession to talented youth.
- Standards, as alternatives to social norms and personal responsibility, become roadmaps for evasion.

What to Do?

- Each jurisdiction would permit two or more competing sets of standards, no monopoly.
- Each company decides which set of standards to use in its reports (i.e., investors react to choice).
- Standards setters would be financed by royalties collected from companies using their standards, and would compete for royalties.
- Companies would be forced to make difficult choices in the hope of identifying better standards through market feedback.

Convergence may or may not occur in this bottom-up approach driven by the market.

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