Rethinking Financial Reporting: Standards, Norms and Institutions

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Full text available at: http://dx.doi.org/10.1561/1400000034
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Foundations and Trends® in Accounting, 2016, Volume 11, 4 issues. ISSN paper version 1554-0642. ISSN online version 1554-0650. Also available as a combined paper and online subscription.
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Abstract

Since the passage of the US federal securities laws more than eight decades ago, much regulatory effort has been devoted to improving financial reporting in business, government and not-for-profit organizations. Yet, evidence on improvements or abatement of misreporting by error or intent remains scarce. In the context of this experience, it may be useful to explore what we might mean by better financial reporting, and how we might define and implement processes to move in that direction. A broad agreement on the way ahead seems necessary to make progress.

Creating and sustaining institutions that follow a stable and conservative process for gradually adjusting the prevailing practices toward any long-term shifts may help evolve a better financial reporting environment. This approach departs from the tendency to issue new rules, often disregarding the lessons of practice, that has created much confusion and failures in financial reporting over the past century. The eagerness to deal with transaction innovations through new pronouncements ends up fueling the cycle of more innovations, misrepresentations and abuse. The enormous resources and attention devoted to written rules have been accompanied by waning professional responsibility for good judgment and regard for practice and practicality. This work argues for targeting a better balance between top-down written rules and emergent social norms as reflected in business and accounting practice through restraining activist institutions of accounting. Suggestions from exploration of whether and how better social norms can be engineered are only preliminary at this time.

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 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 (Former Chair, US Securities and Exchange Commission) in Fingleton and Schoenmaker [1992]
What are, or should be, the properties of a good financial reporting regime? Financial reports serve many masters whose diverse expectations are in frequent conflict. Often, the powerful consider their own personal interest to be paramount. A good financial reporting regime is likely to be the result of creatively bargained trade-offs among its many functions, characteristics, and constituents.

1.1 Attributes, goals, and practice

There are three broad approaches to defining better financial reporting, based on attributes, goals, and practice. The first specifies some attributes of good reporting. Truth is a favorite prescription. Some other judgmental attributes often mentioned include (in alphabetical order) comparability, conservatism, consistency, cost, fairness, neutrality, predictive value, relevance, reliability, representational faithfulness, timeliness, understandability, verifiability, and uniformity. In the absence of quantification and trade-offs, they do provide only aspirational guidance for designing a financial reporting system and help to set the agenda for discussion and analysis. Instead of judgmental
attributes, financial reports can also be characterized by their statistical or descriptive contents. Examples of attributes that fall into this category are: correlation among security prices, volume, and other market, accounting, industry, or macro-economic variables, time series properties of reported variables, the power to predict prices, financial stress, and other future events of interest.

A second approach is to focus on goals of society or of some specified individuals or groups. Generating greater wealth and prosperity for society by enabling organizations to operate more efficiently is an example of a social goal. Distributive justice is equally important to many people. Reducing the cost of capital for reporting entities is another frequently mentioned social goal of financial reporting.\footnote{However, it is unclear why reducing the cost of capital to the investing entities should be socially desirable, when it also means reducing the rate of return to the investors (which is just the flip side of cost of capital). Reducing the price of potatoes simply transfers wealth/income from farmer to consumers without necessarily increasing or decreasing social welfare. What is so special about the price of capital to make this argument inapplicable to that context?}

Narrowing the focus to the goals of participating individuals and groups simplifies the problem. But it also sets aside the legitimate interests of other participants. For example, one could define as good that financial reporting which helps equity holders of a business make more efficient investment decisions. Indeed, a large body of literature in accounting sets out to do just that, possibly because the data on the performance of equity investment is ubiquitously available. The popularity of this approach need not distract one from considering legitimate interests of other individuals and groups such as creditors, employees, communities, and governments in financial reports of organizations.

Looking to practice for guidance on defining and understanding the financial reporting regime is the third major approach. Large parts of accounting, law, medicine, and other professions arise from practice and experience. They are based on what Hayek [1991] called “the extended order”: “... a framework of institutions — economic, legal, and moral — into which we fit ourselves by obeying certain rules of conduct that we never made, and which we have never understood in the sense of which we understand how the things that we manufacture function.” Even for
manufactured things — a car for example — it is not clear how many people really understand how all of their parts function.

The role of social norms that emerge through a myriad interactions among individuals, organizations, and of the socio-economic environment in shaping the financial reporting regime has received only limited attention in recent accounting literature. From a mechanistic perspective, a financial reporting regime may be thought to have been constructed from its elements — perhaps written rules — like a wall is constructed from bricks and mortar. While this perspective dominates accounting discourse, it has proved to be difficult to construct a practical model of accounting from its identifiable elements — the “bricks.” Instead, practice has important emergent properties seen in the extended order, but not in the components. From this perspective, long encapsulated in the traditional meaning of the familiar phrase “generally accepted accounting principles” (GAAP), a financial reporting regime arises from its general acceptance in the community of business managers, accountants, investors, employees, etc.

These three approaches — attributes, goals, and practice — are not mutually exclusive. It is unlikely that any one of them is entirely satisfactory by itself; they complement one another. This book argues that such a syncretic attitude will help to build a better financial reporting regime.

1.2 Perspectives by time scale

Perspectives varied in detail and time often yield different insights into the nature and origins of a phenomenon. For example, walking through a neighborhood, flying over a city, and looking at earth from outer space allow one to see the same surface of the earth in very different ways, and yield related but quite different observations of the dwellings, landscape, and activities observed (see Figure 1.1). We can look at financial reporting also from various perspectives of time and detail. An auditor learns about different aspects of the same firm in checking a sheaf of customer invoices, in conducting an analytical review of the financial statements, or in assessing the performance of an organization over the
years. The facts rarely speak for themselves; what we observe depends on the level of spatial or temporal detail in our chosen perspective, and what we are looking for in a given perspective.\footnote{\url{www.invisiblegorilla.com} has interesting video examples of the phenomenon that people do not notice “obvious” things when they are not looking for them (accessed July 31, 2015).}

Most accounting discourses on a financial reporting regime are focused on the treatment of specific types of transactions and possible ways of altering the treatments through rule-making or other regulatory actions. It takes a longer run view of the consequences of repeated cycles of transaction innovation followed by regulatory action, and includes institutional innovation as well as evolution of social norms as elements of the process that shape the financial reporting regime.

1.3 Rules and institutions

It is useful to think of three levels of analysis in accounting: transactions, rules for classifying and reporting transactions, and socio-political-economic institutions for making, implementing, and enforcing the rules. Since all events are not treated as transactions in accounting, the first level of analysis identifies which events are to be treated as transactions. The second level develops a classification scheme for transactions based on their observable attributes, and chooses how each class of transaction is to be recorded and reported. At the third level
lies the development of institutions to perform and oversee the tasks at the first two levels. Besides the legislatures and courts, bureaucratic regulatory and coordination structures in the government and private sector are examples of such institutions in the United States.

Most accounting instruction concerns the first two levels: learning to identify events that are considered transactions, and to decide how the transactions are to be classified and reported under the prevailing regime. How and why the rule-making institutions choose a particular rule receives less attention in our teaching. Even rarer is the analysis of the alternative design or evolution of institutions. These oft-ignored topics are important because the structure of institutions helps determine the scope and nature of the events they recognize as transactions, and the rules they promulgate.

To understand accounting regimes, a broad perspective on accounting institutions that create the regimes is needed. In the United States, for example, the relevant accounting institutions include not only the obvious candidates such as the federal Securities and Exchange Commission, the Financial (as well as the Government) Accounting Standards Board, the Government Accountability Office, and the Public Company Accounting Oversight Board, but also the American Institute of Certified Public Accountants, state securities regulators and CPA societies, various state and federal courts and industry regulatory commissions and revenue departments, all operating under their respective statutes, charters, regulations, and procedures. Although we shall confine our attention here to the first few larger institutions named above, the role of local institutions such as the chapters of Financial Executives International and the associations of accountants is also important.

1.4 Social norms

While rules and institutions are more formal, a great deal of our lives, including professional practice, is governed by less well-defined social norms. These are shared expectations held of one another’s behavior in the relevant community. In a broader sense, social norms also compose
an institution. Although they have played an important role in all professions and various aspects of our lives, their role in financial reporting has been muted during the recent decades. We shall explore the possible reasons and consequences of this phenomenon and discuss some options for the future.

1.5 Learning and development

Social systems learn, develop, and change over time. To the extent we can design the institutions of accounting, they need to have a built-in capacity to learn and adapt to changes in the environment without being destabilized. Standardization of practice and their adaptation have an inherent conflict. Widely adopted and enforced standards are also more difficult to adapt to environmental changes. For example, the United States was the first to invest large amounts of capital in the mechanization of weights and measures and that standardization made it more costly and difficult to adopt the metric system which is now used almost everywhere else in the world.

In the past two decades, there has been a strong push towards standardization of financial reporting across the globe, accompanied by claims of its benefits. We analyze the consequences of standardization in financial reporting.

1.6 Ways forward

Finally, we explore the future of financial reporting, especially in light of the active interaction among financial reporting, law and financial engineering. The environment of financial reporting is defined in a significant measure by law and financial engineering. To the extent that rules of financial reporting are written down, they facilitate attempts of managers and their advisors to design newer transactions, instruments, and even organizational forms to bypass or defeat the intent of the rules.
1.6. **Ways forward**

Many conflicts and disagreements about accounting and auditing end up in the courts of law for their final resolution. An expanded role for the common law approach where community norms are decisive may help improve financial reporting.

Full text available at: http://dx.doi.org/10.1561/1400000034
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Full text available at: http://dx.doi.org/10.1561/1400000034