Academics and Standard Setters: Partners or Protagonists?

Good evening; thank you Kevin [Stevenson] for your kind introductory remarks.

Tonight I want to address a Question—should academics, like me, and standard-setters, like many of you, regard ourselves as partners, or as protagonists?

> *A protagonist is the main character in a plot… When the work contains subplots, there may be different protagonists … (paraphrasing the discussion of "protagonist" in Wikipedia)*

Many have speculated on gaps between academics and practitioners, between practitioners and standard-setters, and between academics and standard-setters. I'll talk about the last of these combinations, academics and standard-setters.

Some of what I will say will not be new to at least some of you. But I hope there will be something new for everyone, if only in the way I piece the story together.

This is what I will conclude:

> We will make better progress if we see ourselves more as partners with a common interest, and rather less as protagonists pursuing different plots and with different axes to grind.

Let me begin by talking briefly about accounting theory (also known, these days, as a "conceptual framework").

In essence, a theory is a set of law-like statements designed to capture an integrated set of ideas, from which hypotheses may be generated and, ultimately, tested to verify or refute the theory.

An example of a reasonably tightly argued accounting theory is Bill Vatter's "Fund Theory of Accounting". It dates back to his doctoral thesis at the University of Chicago, and it was written in the early to mid-1940s. Here's Vatter's opening paragraph, in which he discusses the need for a theory of accounting:

> "Every science, methodology, or other body of knowledge is oriented to some conceptual structure—a pattern of ideas brought together to form a consistent whole or a frame of reference to which is related the operational content of that field. Without some such integrating structure, procedures are but senseless rituals without reason or substance; progress is but a fortunate combination of circumstances; research is but fumbling in the dark; and the dissemination of knowledge is a cumbersome process, if indeed there is any 'knowledge' to convey."

Vatter's Fund Theory was a beautiful work, but were we to judge it on whether he succeeded in developing a theory of accounting that, in his words, "brought together [a pattern of ideas] to form a consistent whole or a frame of reference to which is related the operational content of that field", with the emphasis on "operational", then I doubt he would have gone on to the stellar academic career he so enjoyed.

I make this comment because Vatter drew a distinction between a concept—for example, an "asset"—and how it was to be measured. But while one precedes the other, in accounting they are closely linked, as Hans [Hoogervorst] reminded us only this morning.

There have been many similar attempts over the years. One definition, or law-like statement, that I particularly enjoy is at least 70 years old. It goes like this:

> "An asset is something represented by a debit balance that is or would be properly carried forward upon the closing of books of account kept by double-entry methods according to the rules or principles of accounting…"

And of course a <u>liability</u> was, correspondingly, defined as "something represented by a <u>credit</u> balance that is or would be properly carried forward… "

Well, at least the authors were open about the difficulties of defining accounting terms, because when these very old definitions were first framed, they did not really know what an asset was, or a liability either, and by extension, how to define earnings or net income. So they must have thought the best way to find out if something is an asset would be to ask an experienced accountant to make a judgment based on practice. Nowadays, of course we know a lot more about conceptual frameworks, don't we?

Incentives

Ever since I was a little boy, I've responded to incentives, although for quite some years, like Eliza Doolittle, I did not appreciate that's what I was doing.

One reason why standard-setters and academics behave differently is that they face, and are responding to, different incentives. Katherine Schipper—many here tonight would know Katherine—pointed this out very clearly in an article published in the 1990's. For those who do not know Katherine, she is a former editor of the *Journal of Accounting Research*, and from 2001 to 2006 she was a member of the Financial Accounting Standards Board in the USA. She summarized, this way, the different incentives we face:

Standard-setters

1. Face judgmental issues—eg, when should an item be recognized and when should it be disclosed?
2. Must decide an issue ex ante (before the event)
3. Need research that is
    a. available "now"
    b. comprehensive
    c. conclusive
4. Need the answer to their question; the research method is less salient

Academics

1. Face an ex post (after the event) question
2. Engage in research that is
    a. time consuming
    b. incremental (most research papers build on earlier work)
    c. especially concerned with the research process

We should also acknowledge the incentives that academics face as employees of universities. Academics tend to be promoted on criteria that emphasise research excellence, which typically means success in publishing in "top" journals. Unfortunately, as Richard Laughlin noted recently, few of the so-called top journals value the policy implications of a study; and indeed some journal editors actively discourage authors from expressing a policy-oriented opinion.

But while these differences can be important, they do not mean we should see ourselves as protagonists. A very good example, to me, of a partnership in action is the mountain of research by academics who have tried to calibrate the extent of the benefits countries have achieved by adopting IFRS in lieu of their own standards. While much of the research is undoubtedly arcane (in that the research methods are understood by only a few), and while the evidence is not unanimous, we can fairly say that the benefits are indeed proving to be real and substantial. At least that is what I recently concluded from a review of more than 100 academic papers on the subject of the benefits of adopting IFRS. Although the evidence is mixed, here is a list of some of the benefits that have been reported:

- improved analysts' forecasts of future earnings
- better access to international equity markets
- higher quality disclosures and earnings
- more efficient stock prices
- more liquid equity markets
- a lower cost of capital

[for more information, see Philip Brown, "International Financial Reporting Standards: what are the benefits?", published in *Accounting & Business Research*, volume 41 number 3 (September 2011), pp. 269-285.]

Why is everything about standards so political?

Not that long ago I sat on a panel at a conference organized by AFAANZ, which has around 500 members and is the leading association of accounting academics in Australasia. A New Zealand accounting standard-setter who sat on the same panel was lamenting, to the audience, that they had to deal with so much lobbying. The clear impression was that this person would have greatly preferred the lobbyists to leave them alone to get on with their work. My own reaction was, "faint hope". It is, of course, a familiar cry.

I suspect most academics consider the standard-setting process is inherently political in nature. I also suspect most standard-setters would like it not to be quite so *overtly* political.

You might wonder why academics believe the process is inherently political in nature. Well, at an abstract level, it follows from Arrow's Impossibility Theorem. (I think we should leave Arrow's Theorem for another occasion, unless everyone is thinking clearly and is ready for theorems and proofs—which I somehow doubt!)

At a practical level, standard-setting is inherently political in nature because accounting standards can affect people's wealth in different ways. As we all know, commercial contracts sometimes refer to how a matter is to be accounted for, so that changes in accounting standards can create winners and losers among the users of the financial statements. And, when people find they are likely to be worse off, usually they do not like it. They then try to influence the decision makers—the standard-setters in this case—so that the outcome, the applicable accounting standard, is more to their liking. That's just a fact of life. What is also a fact of life is that if the standard-setters fail to respond to pressure from vested interests, ultimately the legitimacy of their standards in the eyes of the community can be threatened. I expect we all agree on that statement.

That said, the political nature of standard-setting seems to me to have been taken, recently, to quite another level. Allen and Ramanna, of Harvard Business School, had this to say just a few months ago about standard-setting outcomes in the United States:

> " [FASB] members' and [SEC] commissioners' length of service on the board and a prior career in investment banking/investment management are associated with exposure drafts perceived as decreasing accounting 'reliability;' and FASB members' affiliations with the Democratic Party are associated with proposing standards perceived as increasing accounting 'reliability.' "

Here is a plain English version of their conclusion (my words):

> An ED, if accepted, is more likely to lead to financial statements being
> —less reliable when FASB members & SEC commissioners have been longer on the job [with the SEC or FASB] or have been employed in investment banking or investment management
> —more reliable when FASB members are affiliated with the Democratic Party

Mmmm! But let's not be too hasty in dismissing this view, because Allen and Ramanna formed it after studying the personal profiles of 39 FASB members and 41 SEC commissioners who had a role in issuing 149 FASB exposure drafts between 1973, when the FASB came into being, and 2007.

Nonetheless, I am fairly confident few standard-setters here tonight would consider themselves partners with these folks [Allen and Ramanna]; that is, partners in the sense that you share Allen and Ramanna's view of standard-setters, even though they at least were careful to describe the relationship as association and not causation.

Let's Talk About Accounting Conservatism

One question on which there may be an enduring difference of viewpoints is the importance of acknowledging, thinking about, and maybe even accommodating, accounting conservatism.

I used to amuse my first year accounting classes—which sometimes comprised around 700 highly-charged teenagers in a single lecture theatre—in various ways, such as by referring to accountants as fibbers and story-tellers. It was really about the role of conservatism in financial statements and it was my way of commanding their attention for long enough to introduce them to the literature on accounting policy choice.

Now for some history. Ross Watts, and my colleague Ray Ball for that matter, are both Australians and were graduate students of mine in the same class when I was a very young instructor at the University of Chicago, where they, like me, had enrolled for a PhD. Ross had studied Accounting at the University of Newcastle in New South Wales and it would be fair to say that the accounting course which he took was, at the time, heavily practice-oriented. That meant Ross understood something about the nature of accounting conservatism and how it was practised. After graduating from the University of Chicago, Ross came back to Australia but within a few years he returned to the USA as a faculty member at the University of Rochester, where he joined forces with Jerry Zimmerman. In time they became principal advocates of the "contracting" school, which is often associated with the University of Rochester. The Rochester School emphasized that a company's choice of accounting policies was an outcome of its contractual arrangements, and that conservative accounting policies can be optimal depending on the circumstances.

While this is neither the time nor the place to press the matter, let me simply observe that advocates of accounting conservatism, who often regard themselves as opponents of "neutrality", have a lot of history behind them.

Who are you?

I would like to conclude my remarks tonight by asking you another question: "Who are you?" That may seem like an odd question, so let me re-phrase it: "How do you regard yourselves, as professionals?"

Many if not by far the majority of people active in standard-setting are university-educated, and more than a few have, for at least part of their lives, been employed as academics. For example, Hans Hoogervorst's predecessor, Sir David Tweedie, has a PhD from the University of Edinburgh, where he lectured in the 1970s; he is now a Visiting Professor in the University of Edinburgh Management School. I have already mentioned Katherine Schipper, who is now a Professor at Duke University. Another prominent academic, Mary Barth, a Professor in the Business School at Stanford University, was a member of the International Accounting Standards Board (IASB) from its inception in 2001 until 2009. Currently, Mary is Academic Advisor to the IASB and is the incoming President of the American Accounting Association. Years earlier, when times were better, she was a partner in Arthur Andersen & Co.

Maurice Moonitz, a major proponent of conceptual frameworks, spent most of his long career at the University of California (Berkeley). In the 1960s he was for three years the first director of accounting research for the American Institute of Certified Public Accountants in New York; he then spent another three years on the Accounting Principles Board. And if I can turn the spotlight on Warren McGregor and Kevin Stevenson, you would probably already know that both Warren and Kevin have been closely involved with academia as well as being deeply involved with standard-setting for more than just a year or two. I should also mention Sir Alex Fitzgerald, whose home town was Melbourne. Sir Alex is generally regarded as a "founding father" of accounting education in Australian universities and was a leader in the accounting profession for many years. I could go on, but the point is obvious: we share an intellectual heritage; and while we may emphasise, just like members of the medical profession, different aspects of our professional lives, we do inhabit the same professional world. And, at the end of the day,

> we will make better progress if we see ourselves more as partners with a common interest, and rather less as protagonists pursuing different plots and with different axes to grind.

Well, that’s my view anyway, and I sincerely hope it resonates with you as well. I only wish more of my academic colleagues would see it this way too.