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From Making Judgments to Following Rules: The Evolution of U.S. Accounting

By Alex J. Pollock

American accounting has tended increasingly toward more lengthy, detailed, prescriptive, complex rules, mandated by the Financial Accounting Standards Board (FASB), and away from reliance on the professional judgment of accountants. The accounting scandals of the post-stock market bubble era, the problems caused by the Sarbanes-Oxley reaction to them, and the historical record of the inherent limitations of accounting call into question this experiment with a FASB rules-based approach.

Accustomed as we have become to accounting scandals in the post–stock market bubble era, it has become a little hard to remember that while the bubble was expanding, Americans often congratulated themselves on having the best accounting there was. In one sense, the subsequent disappointments of being cheated are merely the normal and recurring results of overoptimism. As Walter Bagehot wrote in 1873:

> The good times of too high price almost always engender much fraud. All people [this would include accountants] are most credulous when they are most happy; and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity. Almost everything will be believed for a little while.[1]

Nothing has changed since Bagehot's day with respect to these vulnerabilities, which constitute part of what he called "the inevitable vicissitudes" of financial markets.

But in another sense, it is striking that the accounting scandals of our own day have occurred after a vast effort over three decades by the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) to promulgate and enforce more and more voluminous, detailed, specific, and prescriptive accounting rules. Did the problems occur in spite of the rules, or did the project of expanding rules contribute to the problems?

One expert critic, Walter P. Schuetze, a charter member of the FASB, has written:

> The rules for financial accounting and reporting in the USA have become vastly too voluminous, too detailed, too complex and too abstruse. . . . The volume and complexity of those pronouncements have become overwhelming.[2]

Another, Shyam Sunder of Yale University, argues:

> Today, written standards dominate accounting thought, practice, regulation, instruction, even research. Generally accepted accounting principles . . . now describe rules and regulations issued by authorities with power to inflict punishment on those who do not accept them. How and why did financial reporting get caught in the standardization

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> project, replacing norms and professional behavior by written rules and standards? . . . I argue that heavy reliance on standards-based financial reporting . . . has led accounting on a wild goose chase of objectivity without personal responsibility.[3]

Accounting in the Post-Bubble Era

We know that accountants have both suffered and enjoyed the reaction, or overreaction, to the accounting scandals represented by the Sarbanes-Oxley Act of 2002. They have suffered intense criticism; the destruction of a major public accounting firm; the imposition of a potentially quite onerous new regulator, the Public Company Accounting Oversight Board (PCAOB); and the requirements of the notable, or notorious, Section 404 of Sarbanes-Oxley. At the same time, they have enjoyed a bonanza of revenue and profit from these same Section 404 requirements.

While accountants profit from Sarbanes-Oxley, from the perspective of businesses across America, the legislation imposes huge costs, bureaucracy, and requires the diversion of resources; this has earned the SEC and PCAOB unremitting criticism. In response, the agencies blamed accountants for excessive detail, bureaucratic approach, and insufficient exercise of judgment. Needless to say, this is ironic, especially since "it has been the SEC's accounting staff that has, over the years, pressed FASB to issue more and more detailed rules."[4]

It appears that accountants are caught in a difficult conflict between being responsible for making professional judgments while simultaneously being required to follow ever more prescriptive and detailed rules. This tension is not new, but grows more difficult to resolve as the rules and potential sanctions grow longer and more demanding. The long-term trend in American accounting is for rule-following to replace making professional judgments.

It is instructive in this context to contrast the form of the British chartered accountants' audit certificate with that of their American counterparts. The key and classic British requirement is an act of professional judgment: "In our opinion, the financial statements give a *true and fair view* of the state of affairs of the company" (emphasis added). The American version stresses following the FASB's rules: "In our opinion, the financial statements present fairly, in all material respects, the financial position of the company *in conformity with accounting principles generally accepted in the United States of America*" (emphasis added).

In this version there is the reasonable hedge, "in all material respects," but there is no mention of "true." Moreover, there is the recognition that the rules applied are not universal, as would be scientific principles, but rather are particular rules "generally accepted in the United States of America."

The phrase "generally accepted accounting principles" (GAAP) has come in time to mean the opposite of its original and apparent meaning. When introduced in the 1930s, the term actually meant what it seems to mean: those principles which are subscribed to and used by the majority of knowledgeable, reputable practitioners. It was bottom-up and descriptive in the common law mold. Now GAAP means those rules that are mandated by the FASB, whether or not they are generally accepted and even if they are generally opposed. This is top-down and prescriptive in the manner of statute law. The original meaning has disappeared, as the rules-based approach has become dominant.

The international trend may be moving in the American direction. Keith Jones, a British defender of judgment- rather than rules-based accounting, explains:

> The "true and fair view" assessment of a company's state of affairs has been a cornerstone of UK accounting. It is now in jeopardy. Britain and Europe are moving dangerously close to a weak, narrow and limited US-style audit based on technical compliance.[5]

Can it be that the result of three decades of vast effort to produce detailed accounting standards is a "weak, narrow and limited" audit system?

The Tension between Rules and Judgment

The tension between the application of uniform rules and the exercise of professional judgment was well understood long ago, as trenchantly explained by George O. May, one of the deans of American accounting, in 1938:

> There is no doubt a widespread demand for uniformity . . . but I think we have a higher obligation. We should guard against the dangers of unity of form which does not represent corresponding unity of substance.[6]

Indeed, think of Enron's ingenious off-balance-sheet mendacities.

May wrote further, a few years later:

> Similarities of circumstances are seldom more than partial, and the gain from enforced uniformity may therefore be illusory. Moreover, it can be achieved only at the cost of a relaxation of managerial responsibility. . . . Once a prescribed method is established, the management and the company's auditors can be held responsible only for seeing that it is followed.[7]

Not, in other words, for assuring that it is a "true view," only for following the rules. As a related point, it is certainly the case that:

> Technical benchmarks of compliance can never hope to be flexible enough to capture all the issues that arise in a company's affairs.[8]

Rather than naively believing in the idealistic view that financial statements are or ever could be in any simple sense "transparent," those who understand the reality of accounting know that judgment is central and essential to its actual practice. Consider this insightful summary of the matter from a history of accounting theory:

> At the base of a great many arguments in our [accounting] literature are such nebulous, value-charged words as "useful," "rational," "realistic," "logical," " "equitable," "fair," "true," "reasonable," "sound," etc. . . . "going concern," " "objectivity," and "conservative" mean different things to different writers.[9]

The American Institute of Certified Public Accountants (AICPA), a leading accounting professional association, likewise finds that:

> Financial accounting and reporting are not grounded in natural laws as are the physical sciences, but must rest on a set of conventions.[10]

"A set of conventions," alternately stated, means that accounting standards, in addition to being about numbers and techniques, are also inherently matters of politics, philosophy, and fundamentally imprecise ideas, such as those listed above. This is why all attempts to give them a conceptual foundation over the better part of a century have failed, having simply broken down into competing, mutually inconsistent theories—just like politics or philosophy. It is also why the notion that accounting standards can be left to a committee of technical experts is a fallacy.

In the 1940s, there was a lively debate within the accounting profession about rules as opposed to judgment:

> The big firms disagreed whether "uniformity" or "diversity" of accounting methods was appropriate. Arthur Andersen & Company believed fervently that all companies should follow the same accounting methods in order to achieve comparability. But such firms as Price Waterhouse & Co. and Haskins & Sells believed that comparability was achieved by allowing companies to adopt the accounting methods that were most suited to their business circumstances.[11]

It is ironic that the theory espoused by Arthur Andersen, which met its demise in the Enron scandal, has prevailed in the historical development of accounting in the United States. The obvious judgmental nature of accounting notwithstanding, American accounting has tended more and more to ever longer and more detailed rules in the attempt to create a uniform rule set to cover all circumstances.

A necessary corollary is that the practice of American accounting, including the training of accountants, has focused more and more on rule-following, as opposed to making judgments. In my experience, a principal item in corporate audit committee meetings is the external accountants explaining what new FASB standards they now have to follow. There is usually no discussion about what the rule should be. It is a compliance discussion, not a conceptual discussion.

Accounting Firms Become Rule-Followers

Stephen A. Zeff, a prominent and authoritative historian of the evolution of accounting, describes a profound corresponding change in the accounting profession itself. The major accounting firms used to have serious intellectual debates publicly in their journals about what the right accounting standards were. No longer:

> All of the Big Eight firms' house organs that occasionally contained technical articles on accounting and auditing either closed down or became entirely non-technical. . . . Between 1971 and 1973, four Big Eight firms began to publish a series of widely distributed booklets expressing their views on

> controversial accounting issues, but all of these series terminated. . . . By the mid 1980s all of the firms' newsletters had become entirely factual, evidently steering clear of the espousal of controversial views on matters of accounting principle. Even the state societies of CPAs began discontinuing their journals or replacing them with bland magazines having little, if any, professional content.[12]

By 1991, reflecting on the interaction of accounting firms with the FASB, one observer concluded: "Many attesters [accounting firms] seem to have lost their ability and/or willingness to present their own views."[13] Even by that point, the evolution from judgment-makers to rule-followers was apparently well advanced.

The existence of an organization—the FASB—whose sole reason for being is to generate accounting rules naturally guarantees that there will be a continuous production of more rules, and that these rules and their interpretations will grow in complexity because of an inevitable internal dynamic.

As the conceptual and philosophical responsibilities are taken over by this government-sponsored standards monopoly, the accountants become subsidiary bureaucrats, focused on compliance. In one sense, their lives become less demanding, with an economic inducement to cede intellectual and professional responsibility.

As Sunder explains:

> The very existence of the rule making agency encourages accountants to submit requests for "clarification" instead of persuading their protesting clients on the basis of professional judgment and general acceptance. When the client disagrees with the auditor on accounting treatment of an event or a transaction, it is easy for the client to ask: Can you show me the rule? . . . Audit firms have rewarded their partners for "rainmaking" [i.e. sales], not for the qualities that prevailed in an earlier era—technical mastery, professional judgment, and the respect they commanded from their colleagues inside and outside the firm.[14]

One source of the historical support for accounting standards set by a committee of technical experts was the rather naïve belief that such a body could produce research that would resolve "the intractable philosophical differences between leaders of the accounting profession."[15]

This naïve view regularly reappears. One U.S. senator recently stated, for example: "It is critically important to keep U.S. accounting rules out of politics, which means allowing the experts at FASB to do their work."[16]

The advocates of such positions have been characterized from a more realistic perspective as follows: "High-minded people in sensible shoes who believe that if politicians would just stop being so parochial and short-sighted—or better yet would turn things over to an independent committee—all our problems would be easily solved."[17]

Enter Sarbanes-Oxley

The evolution of accounting toward rule-following behavior appears to be an important element in why the accounting firms have implemented Sarbanes-Oxley requirements in the extremely costly, brute force, bureaucratic way they have—for which, as discussed above, the SEC and the PCAOB have (quite ironically) criticized them for insufficiently exercising professional judgment.

Here the long-term rules-based trend is hitting the real business world in a very direct and expensive fashion, as described in an excellent letter from the Mortgage Bankers Association to the SEC:

> The Sarbanes-Oxley Act has created an atmosphere of near paranoia, where auditors generally conclude that more testing and documentation is always better regardless of the cost or benefits. This is sapping our resources to the detriment of investors.
>
> This activity results from highly ambiguous terms such as "remote likelihood," "more than inconsequential," "reasonable assurance," "material weakness," or "significant deficiency."
>
> The amount of testing being performed within our industry appears to be aimed at providing absolute assurance, which is, of course, an illusory concept.
>
> Our members think that any concept of materiality is gone. Everything and anything is deemed to be material because *the public accounting firms themselves have increased their aversion to risk to an extreme degree* (emphasis added; note that this indicates classic bureaucratic, not professional, behavior).
>
> Almost every significant audit-related decision is now being referred to the firm's national offices

> rather than being addressed at the practice level. (i.e., please tell me what the rule is!)
>
> We've been told that auditors can no longer help with the application of GAAP because that might be a conflict of interest to advise your client.[18]

Note especially this last point: consultation with your accounting firm regarding the proper application of accounting standards may be viewed as an internal control deficiency! This is the reduction to absurdity of the audit relationship. Is this where the elaboration of the rules-based approach has brought us?

Often in Trouble

Accounting debates occur with historical regularity, which must tell us something about the fundamental nature of accounting and the tension between judgment and rule-following. It is hard to find a decade when the accountants have not been in trouble.

Consider this situation:

> Now all at once there are more than 50 major lawsuits pending against the big public accounting firms, which handle about 80% of the U.S. auditing business of listed companies, charging irregularities and negligence in preparing earnings reports and other financial statements. . . . With equal suddenness a barrage of public criticism has landed on the profession.[19]

The year? 1967.

Going back further, the accounting profession was caught in the scandals of the 1920s stock market bubble, when charges of "deceptive and misleading financial reporting practices" were lodged against it. [20] In response, in 1930 the American Institute of Accountants created a committee "to address pressing concerns in financial reporting," and in 1932, created a "special committee on the development of accounting principles."[21]

In 1938, there was "the gigantic McKesson and Robbins auditing scandal"—the Enron of its day—"greatly embarrassing the profession." "Like a torrent of cold water the wave of publicity . . . has shocked the accountancy profession into breathlessness," wrote the editor of an accounting journal of the day. In response, the Institute formed a committee "to promulgate a series of bulletins on auditing procedures."[22]

"Toward the latter part of the 1950s, the accounting profession was subjected to a barrage of criticism" [23] and, after that, "The latter half of the decade of the sixties was a period of unprecedented stress for the individual members and institutions of the accounting profession . . . a wave of criticism of corporate financial reporting . . . a serious challenge to our ability to perform a mission."[24]

Then in 1970, "the largest bankruptcy in history"—the Penn Central Railroad—"called into question not only the regulators' but also auditors' effectiveness."[25] Following a series of special committee recommendations, FASB was formed in 1973. But by 1977, accounting was in hot water again: "Highly publicized bankruptcies . . . bring calls for government intervention."[26]

Starting in 1985, accounting was the subject of numerous congressional oversight hearings, including the role of accounting firms in the vast savings and loan collapse. In the midst of these, a special National Commission on Fraudulent Financial Reporting issued its report on improving accounting (1987). At about the same time, two professors asked, "Will the FASB survive?"[27] It did. But did the balance between judgment and rules survive?

As we have said, it is hard to find an extended period in which accounting has not found itself in some kind of trouble. Over a number of decades, the answer has always been: "more rules." Now we have the post-bubble scandals and the most recent response in the form of Sarbanes-Oxley. "The spate of accounting and auditing failures of the recent years," writes Sunder, an eminent student of the subject, "raise questions about the wisdom of this transition from norms to standards"[28]—or, in our words, from judgment to rule-following. Zeff described the evolution of the accountant "from technician to professional"[29]; perhaps the stress on rule-following has reversed this transition.

Has the FASB-era experiment with ever longer, more detailed, more prescriptive, more complex accounting rules been a success?

Debate continues. For example, Zeff and Michael H. Granof have commented that:

> Few accountants will deny that the FASB was unable to close accounting loopholes as rapidly as Enron and Andersen created them. And few will deny that fast and loose reporting practices are all too common.[30]

This after three decades of FASB's efforts!

Here are two citations on a more general level:

> What is necessary is a comprehensive overhaul of the [accounting] model itself. The model was designed for the industrial era. . . . It fails miserably when the critical resources of a firm are software, intellectual capital, brand names and fiscal wizardry.[31]

> The current standard-setting process is fundamentally antithetical to the culture and the possibilities of the Internet.[32]

One clear conclusion is that financial statements, while extremely useful, are—under any regime and regardless of the volume of rules which govern their preparation—subject to inherent limitations. This needs to be widely understood. As a conference of the SEC concluded in 1977, "there was a need to apprise investors of the inherent lack of precision in the numbers contained in financial statements."[33] It was acutely observed a decade before that:

> A company's greatest asset will never appear on any audited statement: the quality of the company's management and the validity of its corporate philosophy. . . . The smart investor will do well to remember that it's the intangibles that really count—and no accounting system can ever measure them.[34]

Multiple Perspectives?

Given the limitations of accounting under any set of rules, an intriguing possibility is to replace the monopoly standards-setter with a market-like system of multiple, competing standards, as Sunder suggests. He suggests further that given the advances in computer technology, we could now take seriously an idea originally discussed in the 1940s: "Making basic accounting records available for alternative aggregations by various users"[35]—in other words, decide which accounting principles you believe in and create your own version of the financial statements accordingly.

Financial analysts, to the extent the data is available, do this routinely.

Finally, we should give up the idea that truth is ever captured in one, however uniformly prepared, set of summarized abstractions known as a company's financial statements, and adopt instead the superior principle that reality is better approached through multiple perspectives.

It is certain that electronic computing, data storage and manipulation, and communication make practicable the expression of multiple accounting perspectives, which was simply not possible in the past. The insistence on a single mandated perspective based on a single set of accounting rules probably reflects the historical constraints of paper records, which had to be produced by the aggregation of detailed numbers recorded on paper, originally with pen and ink, to form summary numbers on paper. Perhaps the change in the technological basis of accounting records will in time lead to a change in the idea of what constitutes accounting.

Companies will continue to prepare their GAAP financial statements. They should also explain to investors, creditors, and counterparties how they actually conceptualize and manage the business. This could involve producing additional financial statements reflecting the non-GAAP perspectives needed to create accounting representations approximating the economic truth as they believe it to be. This implies multiple statements, multiple perspectives, and "true and fair views (plural)." Truth is likely to be more closely approximated in this fashion than it would be using a single, official perspective requiring ever more elaborate rules. However, this project also requires integrity, knowledge of the business, and informed judgments about truth and fairness.

Here would be a challenging assignment for employing the professional judgment of the accountants of the future.

Notes

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26. Ibid., 10.

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