Research Article

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Have Academic Accountants and Financial Accounting Standard Setters Traded Places?

Abstract: The basic premise of this paper is that academic accountants and financial accounting standard setters have traded places in their normative vs positive orientations. Academics have shifted from normative to positive, while standard setters have shifted from positive to normative. This paper was developed from a speech given at the August 2012 American Accounting Association Annual Meeting, which was followed by speeches by Ross Watts, Richard Macve, and Steve Zeff on the same subject. Ross Watts argued that a lack of understanding about accounting history and evolution is a likely source of problems. He also summarized the recent evidence in (Allen and Ramanna (2013). Towards an understanding of the role of standard setters in standard setting. Journal of Accounting and Economics, 55(1), 66–90) on the association between standard setters’ backgrounds and the positions they take. Richard Macve added UK and IFRS perspectives (Macve, R. (2013). “Trading places”: A UK (and IFRS) comment. Accounting, Economics, and Law, 2014;4(1):1–14), and Steve Zeff provided a more in-depth historical perspective (Zeff, S. A. (2013). Some historical reflections on “Have academics and the standard setters traded places?” Accounting, Economics, and Law, 2014;4(1):1–8).

Keywords: accounting standard setting, accounting regulation, accounting research, accounting academics

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1 Introduction

Standard setting is inherently a normative exercise. Nevertheless, there is a choice to be made about whether or not to have a positive orientation. By a positive orientation, I mean observed practice serves as the starting point we try to understand, abstract from, and generalize. By a normative orientation, I mean an attempt to prescribe what practice should be without reference to existing practice. Our identities, particularly as accounting researchers, seem to have been wrapped up in the normative/positive dichotomy. I hope this paper’s attempt to use the dichotomy will be useful as a way to frame a discussion about not only our (the academic accountant’s) history but also the history of the accounting standard setters, our interactions with them, and how those interactions might be improved.

2 The trade

So, when did we trade places with the standard setter? I will pick on 1973 and the Financial Accounting Standard Board (FASB), but it is difficult to defend any single year as the “moment of change.” The 10 years or so on either side of 1973 seems to be the formative period of the trade.

As an academic discipline in the US, accounting is about 100 years old. Much, although certainly not all, accounting research done prior to the 1970s was normative. This research is sometimes pejoratively, and I think unfairly, referred to as “arm-chair” research – that these were merely the (well-reasoned) opinions of accounting scholars rather than more substantive research efforts. The American Association of University Instructors in Accounting was formed in 1916 and renamed itself the American Accounting Association (AAA) in 1936. Three of the most important leaders of the AAA during its first 20 or so years were Eric Louis Kohler, A. C. Littleton, and William A. Paton. Paton’s (1922) dissertation, later expanded into the book Accounting Theory, was revered. As
part of the Executive Committee of the AAA, Kohler, Paton, and Littleton wrote the 1936 “A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements.” Perhaps the best-known example of the academic approach of the day is Paton and Littleton’s (1940) AAA Monograph *An Introduction to Corporate Accounting Standards*. Subsequent academic efforts include the Moonitz (1961) and Sprouse and Moonitz (1962) research studies sponsored by the AICPA and the AAA’s *A Statement of Basic Accounting Theory* (ASOBAT) in 1966. These were all highly regarded efforts but seem to have had a limited direct impact on the standard setters.\(^1\)

There were exceptions to the normative orientation. Sanders, Hatfield, and Moore’s (1938) *A Statement of Accounting Principles* (SHM) was widely criticized for being too permissive and lacking the rigor of, for example, Hatfield’s (1927) textbook, *Accounting: Its Principles and Problems*. I heard from Maurice Moonitz how frustrated Hatfield was by the collaboration. Nevertheless, the monograph has redeeming features. Yuji Ijiri used the monograph in his PhD seminars as an early example of positive accounting theory. As Storey (1964) wrote, SHM was “the first relatively complete statement of accounting principles and the only complete statement reflecting the school of thought that accounting principles are found in what accountants do – the school which emphasizes the accepted part of ‘generally accepted accounting principles’.” According to Storey, SHM was the “first major building block in the structure of accounting principles.”

By the accounting standard setter, I refer to those in the US: the Committee on Accounting Procedure (CAP) from 1939 to 1959, the Accounting Principles Board (APB) from 1959 to 1973, and the FASB from 1973 onward – always with the Securities and Exchange Commission (SEC) as the 800-pound gorilla lurking in the background.

George O. May, a senior partner at Price Waterhouse, served as vice-chairman of the CAP but was the de facto chairman. May was an English chartered accountant before emigrating to the US in 1897. He believed in an evolutionary approach to standard setting, with practice taking the lead and ample disclosure to ensure the user would know which of the accepted accounting methods had been chosen (May, 1958). This was the era of Generally *Accepted* rather than Generally *Imposed* Accounting Principles. Before the CAP, May chaired the

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\(^1\) Storey (1964) suggests the primary impact of the AAA statements was through (1) dissemination in classes taught at universities and (2) the influence of the pronouncements on leading practitioners who, in turn, influenced accounting practices at major companies. As Zeff (2007) observes, the SEC and its chief accountants have been key in supporting (even directing) various positions of the standard setters. The AAA, and the 1936 “Tentative Statement” in particular, had some influence via the SEC. See also Biondi and Zambon (2013).
blue-ribbon committee of the American Institute of Accountants that in 1934 coined the term “accepted principles of accounting.”

The APB narrowed the set of acceptable alternatives, sometimes mandating entirely new treatments. At the same time, the Board was widely criticized for not being independent enough and taking an ad hoc approach to standard setting. At the recommendation of the Wheat Committee of the AICPA (American Institute of Certified Public Accountants [AICPA], 1972), the FASB was established in 1973 as a remedy.

Arguably, the most influential of the studies carried out by a committee of academics on a financial accounting standard setter was the Report of the Trueblood Study Group (American Institute of Certified Public Accountants, Report of the Study Group on the Objectives of Financial Statements, 1973). Although the Study Group was comprised of practicing accountants, financial executives, and academics, academics dominated the research staff. The Study emphasized the decision usefulness perspective, which is an approach George Staubus (who was not associated with the Study) advocated as early as 1954 (Staubus, 1999). Roughly stated, the FASB co-opted many of the ideas in the Trueblood Report but also took on the development of a conceptual framework (and accounting theory, in general) as its own work, despite the Wheat Committee’s suggestion that a “fundamental research program dealing with basic concepts ... is best left to those in the academic field” (AICPA, 1972).

Meanwhile, academics had moved on. Ball and Brown (1968) and Beaver (1968) began a revolution that had us using data to understand the role of accounting in capital markets. With Watts and Zimmerman (1978), a particular school of positive accounting theory was born, although almost everything published in the leading accounting journals since that time can be characterized as positive accounting research. We had emerged as social scientists rather than social engineers, and our status within the university was no longer in need of defending.

3 Prince or Pauper?

So, was the trade a good one? Did we wind up as Prince or Pauper? I think the trade was mostly a good one for academic accountants. The positive revolution brought us a deeper understanding of some of accounting’s roles. Nevertheless, there are many symptoms things could be improved by a broader approach, embracing more varied research contributions, including the topics we study,

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the social sciences we build on and contribute to, and renewing our interest in normative research. We have left a lot on the table.

I am less sure the trade was a good one for the FASB. Although it is unclear that the FASB’s conceptual framework has played a central role in its development of specific standards, characteristics of the conceptual framework are emblematic of general problems with the normative approach to standard setting. Instead of embracing concepts that have stood the test of time such as conservatism and matching, these concepts are now described in pejorative terms (see, for example, Financial Accounting Standards Board [FASB] Con. 8, 2010, para BC3.27). As Littleton observed in the context of lower-of-cost-or-market valuation of inventories, accounting conservatism dates back to at least 1406 (Littleton, 1941). Why has accounting conservatism been such a pervasive and enduring feature of accounting? Is conservatism fundamentally designed to avoid premature payouts (e.g. of dividends or managerial bonuses), to combat managerial optimism, etc.? Does the FASB see it as important to understand the role of enduring practices (a positive view), or is their conceptual framework to be a normative exercise devoid of context?

Instead of the earlier tradeoff between relevance and reliability, which Herz (2013) continues to use, the current conceptual framework puts relevance above all else as the single objective to be maximized subject to a minimum representational faithfulness constraint (FASB Con. 8, 2010, para QC18). In its deliberations, Board members argued that the concept of reliability is not well enough defined to be useful. My reading of Ijiri (1967) is that this critique is misplaced. Another example is the claim that assets and liabilities are primary and revenues and expenses are secondary, because it is impossible to define the latter without referring to the former. Inevitably, we define stocks in terms of flows and vice versa. More importantly, why does a definition tell us anything about what is primary? See also Bromwich, Macve, and Sunder (2010) who argue that appealing to Hicks in justifying the asset/liability approach is superficial. There also seems to be confusion about the role of accounting as an input to valuation rather than valuation per se and the nature of the accounting object, for example, focusing on the role of employee stock options as equity instruments rather than their role as incentive contracts.

The standard setter’s focus on decision usefulness seems to be grounded in the work of Trueblood Report, which itself was based on leading accounting theory of that time period. Since then, theoretical work in accounting has moved on – first to decision theory (e.g. Demski, 1972 and Feltham, 1972) and then to strategic interactions/game theory (e.g. Arya, Glover, & Sunder, 1998 and Demski, 1998). The uses of financial statements the FASB labels as decisions by shareholders and lenders are fundamentally strategic. That is, rather than single-person decision problems, these are games played between players who
try to anticipate each other’s actions. Shareholders have what can be described as relational contracts with the managers of the firm. Shareholders buy, hold, or sell their shares based on ways managers find to convey their talent, diligence, and trustworthiness. Shareholders act as if they know this is a game. Why else would smooth earnings, meeting analyst forecasts, and a lack of surprises in general be so important to shareholders (Arya et al., 1998; Demski, 1998)? I know of no decision-theoretic model that could explain this behavior. A particularly important difference between decision and strategic settings is that more information is not always valuable in strategic settings.

We have to be clear about the object(s) of our analysis. In Demski (1998), manipulated reporting about a firm’s sequence of “true earnings” provides more informative signals about the manager’s stewardship, because only a hard-working (or talented) manager is able to forecast the future well enough to deliver a smooth ride. A reasonable claim made by standard setters is that incentive contracts are too situation specific to be the focus of their standards. A firm is nevertheless inherently entangled with its managers and incentive issues rather than a bundle of mechanical projects. How can we design sensible accounting without taking those incentive issues (at a broad level) into account?

My impression is that, when the FASB takes incentive issues into consideration, it does so implicitly, for example, by incorporating conservatism in particular standards and/or in responding to particular abuses by preparers and their financial engineers in designing transactions to get around existing standards. Would it be more productive to be explicit about incentive and other strategic considerations?

On the academic side, we have our own laws and outlaws. Academics, as individual researchers or part of a committee, who offer alternative conceptual frameworks or weigh in with views on policy issues, are accused by other academics of wasting time by offering opinions that standard setters are not interested in. Instead, researchers are called upon to provide evidence, which usually means run a regression, because that is our comparative advantage. These regressions are often oversold, alluding to causality although usually being careful not to claim it outright. Incorporating econometric tests to deal with endogeneity, or at least discussing it, has only recently become standard fare in accounting, perhaps only since Demski’s 2003 Presidential Lecture (Demski, 2004).

3 The AAA’s FASC Committee took a different approach under the leadership of Robert Colson and Karim Jamal in the late 2000s, weighing in on conceptual matters and trying to lead rather than follow the standard setters. See, for example, Ohlson et al. (2010).

4 Do we spend enough time discussing the broad issue of endogeneity in our courses? For example, in trying to do a better job of educating our students about finance and asset pricing models in particular, it seems important we also teach students about the limitations of asset pricing models (and partial equilibrium economic analysis, which serves as the foundation for
view themselves as essentially research assistants to the standard setters. Should we accounting academics worry about our own independence from the FASB?

We have lost interest in our own history of thought. The current generation of accounting academics seems to be largely unaware of anything that came before Ball and Brown and sometimes anything that was published more than 10 years ago. We are also increasingly a-theoretical. In many papers, hypotheses seem to be afterthoughts, or at least not a core contribution of the paper. We tell PhD students not to write papers that include both a formal model and a test of that model because of the difficulty of getting such a paper published.

Structural estimation, which is an important policy tool in economics, is virtually non-existent in accounting research. (Li’s (2013) research on team incentives in the C-suite is a recent exception.) One of the most appealing aspects of structural estimation is that the approach can address counterfactuals (e.g. how much agency costs would increase or decrease if a new regulatory policy or change in auditor liability rules is introduced).

Theorists are also to blame. In economics, one of the important roles academics play is in developing new language and economic tradeoffs for policymakers to consider. Why is that true in economics but not in accounting? Most of our models incorporate, at best, limited accounting structure. Moreover, we seem content to test our models by the ring of truth they have to the author rather than rigorous empirical testing. Finally, most of our results rely on fine-tuned optimal arrangements tailored to specific situations and details of the environment rather than the wide variety of situations the standard setter has to design standards for.

4 The legacy of W. W. Cooper

An advantage of an applied discipline is that it has available to it a rich source of real problems. An ideal outcome of research on one of those problems is that it generates a novel and insightful solution that can be applied to many other problems – this is a way accounting has and can continue to extend its academic reach by enticing academics in other fields to join us in the search for major innovations. William W. Cooper, an architect of modern management education and research who passed away in June of 2012 at the age of 97, built his and his students’ oeuvre on this approach.
Bill’s work helped create management science and the modern science-oriented, interdisciplinary business school most of us work at. Part of Bill’s story was that he was able to enlist a mathematician, Abraham Charnes, to join him in solving what were often accounting problems. Bill was also deeply influenced by his mentor Eric Kohler and their accounting and auditing-related work experience together at the Tennessee Valley Authority, US Bureau of the Budget during WW II, and on the Marshall Plan after the War. Before all that, Bill was in the room when Paton and Kohler were working together on the 1936 AAA “Tentative Statement.” Bill also attended the very first meeting of the AAA under its new name in 1936.5

Is it any surprise that performance evaluation was the motivation for Bill’s development of, for example, Data Envelope Analysis with Charnes, Cooper, and Rhodes (1978) Bill was too big to be cast as an accountant alone, but his research is a compelling example of the potential reach of accounting across disciplines. Bill had a profound impact on the next generation of accounting scholars, for example, on Yuji Ijiri who was one of his many PhD students.6 Is accounting as a discipline still capable of attracting and producing broad and ambitious scholars of their stature?

5 Recommendations

I conclude with a short list of recommendations intended to improve the productivity of our future interactions with the FASB.

Accounting academics should consider:
1. being better students of accounting history and thought;
2. taking a more active role in conceptual work, including the development of alternative conceptual frameworks and, in general, playing a greater role in leading rather than following standard setters;
3. using a larger set of econometric tools such as structural estimation that could provide more policy-relevant research.
4. conducting more research that tests formal models;

5 From an interview conducted by the author and Stephen A. Zeff with William W. Cooper in January of 2012.
6 As an aside, I find one of the best examples of accounting research, Ijiri’s (1975) AAA Monograph Theory of Accounting Measurement, difficult to classify as either normative or positive.
5. viewing accounting as a rich source of applied problems that can continue to drive innovation throughout the business school and university, enlisting colleagues from other disciplines as collaborators;
6. embracing a wider variety of research methods, topics, and orientations, including renewing our interest in normative research.

The FASB should consider
1. adopting a more positive view of accounting standard setting;
2. deferring to academics on accounting theory, including the development of alternative conceptual frameworks;
3. seeking a better understanding of the limitations of existing accounting research methods;
4. promoting more policy-relevant research, including the use of approaches less common in accounting than in other closely related disciplines such as finance and economics.

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References


