

## Articles

### ACCOUNTING'S NADIR: FAILURES OF FORM OR SUBSTANCE?

Daniel Austin Green<sup>1</sup>

#### I. INTRODUCTION: "ARE BEAN COUNTERS TO BLAME?"<sup>2</sup>

To read some media reports over the last two years, a recent accounting change--the implementation of FAS 157 by the SEC in November 2007--seems to have single-handedly plunged the worldwide economy into crisis.<sup>3</sup> The traditional stock character accountant, however, is a mindless bean counter whiling away the hours doing boring, repetitive work.<sup>4</sup> So are accountants hapless fools oblivious to their roles in

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1. Fellow, Liberty Fund, Inc.; JD, Benjamin N. Cardozo School of Law (2006); MA (economics), The New School for Social Research (2005); BS, University of Tennessee at Chattanooga (2001); CPA (State of Tennessee). Thanks are due Lord Brian Griffiths of Fforestfach, Alberto Mingardi, Hans Eicholz, and Elaine Sternberg for invaluable comments and discussion on these matters. Special thanks, also, to Tom Martin and David Alvis, whose questions and conversations prompted me to write this piece. Portions of this paper were the basis for a talk at an Instituto Bruno Leoni conference in Rome in July 2009, and the paper was also presented at the International Conference of Accounting, Business, Leadership and Information Management in Yabuli, China in August 2009; at both events I benefited greatly from the discussion.

2. Andrew Ross Sorkin, *Are Bean Counters to Blame*, N.Y. TIMES DEALBOOK BLOG, July 1, 2008, available at <http://dealbook.blogs.nytimes.com/2008/07/01/blaming-the-bean-counters/>.

3. See *id.* (discussing role of accountants in the 2008 financial crisis); Louise Store, *A Values Debate (Not the Political Kind)*, N.Y. TIMES, May 16, 2008 ("[B]ankers complained that they have felt pressured by accountants and regulators to undervalue assets in recent months."), available at <http://www.nytimes.com/2008/05/16/business/16place.html>; Josh Fineman & Ian Katz, *Robert Rubin Says Mark-to-Market has Done 'Damage' (Update2)*, BLOOMBERG.COM, Jan. 28, 2009 ("I spent my whole life at Goldman Sachs believing in mark-to-market accounting, and having said that, if you look at the experience from the last two years, I think mark-to-market accounting has led to terrible vicious cycles in asset prices," Rubin, the former U.S. Treasury secretary, said . . . ."), available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aeaJxuGtTSbc&refer=home>.

4. See Melody Petersen, *Shortage of Accounting Students Raises Concern on Audit Quality*, NY TIMES, Feb. 19, 1999, (noting a former accounting firm intern's complaint that,

devastating the lives of millions upon millions around the world, or are they Machiavellian masterminds manipulating their friends and foes alike to establish their absolute power over the wills of the masses over which they lord? Or are accountants not really to blame at all? Perhaps accounting has been misunderstood and mischaracterized by accountants and non-accountants alike? Has accounting become a harbor in which to anchor false hopes of stability and objectivity in the world of finance? Or are public accountants truly culpable and not yet even fully suffering the consequences of getting exactly what they asked Congress for: the exclusive franchise to audit SEC-regulated companies?<sup>5</sup>

From early twentieth-century power grabs<sup>6</sup> by Certified Public Accountants (CPAs) through today's tumultuous environment, accounting has become increasingly political.<sup>7</sup> Even a standard intermediate accounting<sup>8</sup> textbook declares in boldface: "Accounting standards are as much a product of political action as they are of careful logic or empirical findings."<sup>9</sup> And students are taught that there is a large "expectations gap--what the public thinks accountants should be doing and what accountants think they can do."<sup>10</sup>

Financial accounting exists primarily to convey historical financial information to interested parties both inside and outside the reporting entity. The SEC itself recently confirmed that the investor (either current

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"'Accounting is stable' . . . 'but it's not exciting because you're doing the same thing over and over.'"), available at <http://www.nytimes.com/1999/02/19/business/shortage-of-accounting-students-raises-concern-on-audit-quality.html?pagewanted=1>.

5. See generally Sean O'Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741, 741 (2004) (arguing that the lack of true independence by auditors "will be resolved only by returning to its origins in the federal securities laws of the 1930s and by restructuring the relationships involved in public company audits.").

6. See *id.* at 775-89 (describing how the desire for professional recognition by accountants drove many accounting reforms).

7. See generally D. R. MYDDELTON, UNSHACKLING ACCOUNTANTS 128-41 (Chapter 7, *Political Interference*) (2004) (discussing politicians in the U.S., U.K., and EU reacting to accounting scandals with laws that do not necessarily address the underlying problems but allow for political grandstanding and the illusion of quick and meaningful reform), available at <http://www.iea.org.uk/files/upld-book241pdf>.

8. Intermediate accounting is an upper-level undergraduate course often used, at least in a de facto fashion, to weed out those who will not finish a degree in accounting. It is the primary course in which financial accounting is dealt with and has expanded to a two or even three course sequence at most schools. As the literature and standards grew, so too did the 'basic' course in financial accounting--from one semester to one year, or even three semesters.

9. DONALD E. KIESO ET AL., INTERMEDIATE ACCOUNTING 15 (10th ed., 2001).

10. *Id.* at 17. See also Richard I. Miller & Michael R. Young, *Financial Reporting and Risk Management in the 21st Century*, 65 FORDHAM L. REV. 1987, 2016 (1997) (noting "the gap between the perception of the professional's responsibility and the professional's responsibility in fact").

or potential) is the primary user of financial statements and declared: "Accounting standards should continue to be established to meet the needs of investors."<sup>11</sup> Accountants select the data and data presentation that investors use to make decisions. Exercising judgment is, in part, why some characterize the evolution of public accounting as "the rise from technician to professional."<sup>12</sup> Contingencies must be disclosed *today* but are, by definition, imprecise and uncertain in nature.<sup>13</sup> Beyond financial accounting, other branches of accounting are similarly (or perhaps even more) forward-looking, such as tax accounting (and planning), managerial or cost accounting,<sup>14</sup> and business valuation.

Accounting may not be blameless in the world's current financial woes, but neither can it be the only culprit. But who or what even represents accounting as an institution? That is, to the extent accounting bears blame for current financial problems, what individuals or organizations could be found at fault or should even be investigated? Many organizations, both public and private, with similar and even overlapping authority and responsibilities, exercise simultaneous influence and control. Nor is there much jurisdictional competition, especially *within* the U.S.<sup>15</sup> Accounting is regulated by a complex and expanding set of

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11. *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* 9 (Office of the Chief Accountant, Division of Corporation Finance, U.S. Securities and Exchange Commission 2008) [hereinafter 2008 SEC Report]. "Beyond meeting the information needs of investors, general-purpose financial reporting has secondary uses that may be of additional utility to others, such as for prudential oversight." *Id.* at 9-10.

12. See generally JOHN L. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION: FROM TECHNICIAN TO PROFESSIONAL* (Vol. 1, 1896-1936, 1969; Vol. 2, 1937-1969, 1970) (discussing the history of the shift from viewing accountants as technicians to viewing them as professionals) [hereinafter CAREY, Vol. 1 and CAREY, Vol. 2, respectively].

13. The Financial Accounting Standards Board ("FASB") says "a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a 'gain contingency') or loss (hereinafter a 'loss contingency') to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. *Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.*" ACCOUNTING FOR CONTINGENCIES, Statement of Fin. Accounting Standards No. 5 (Fin. Accounting Standards Bd. 1975), available at <http://www.fasb.org/pdf/fas5.pdf>.

14. "Management accounting, which entails use of accounting information for planning, decision making, and control, developed to accommodate and support these 'profit-seeking activities of entrepreneurs for whom multiprocess, hierarchical, managed enterprises were more efficient than conversion processes through continual transactions in the marketplace.'" Olufunmilayo B. Arewa, *Measuring and Representing the Knowledge Economy: Accounting for Economic Reality Under the Intangibles Paradigm*, 54 BUFF. L. REV. 1, 33 (2006).

15. Although corporate law is commonly discussed in the context of jurisdictional competition among states trying to attract businesses, accounting is almost exclusively national in character. One benefit of this is that accounting has avoided the race to the bottom or top debates that have divided corporate law scholarship. For arguments

governmental, quasi-governmental, and non-governmental organizations which work to further the special interests of CPAs and also struggle amongst themselves for greater control, as is discussed in Part II of this article. Accounting's biggest flaw is found in the way the profession is organized. To say that accounting has too many quasi-regulatory bodies does not require a commitment to deregulation, although that is one potential solution to accounting's organizational disaster.

The legal literature on accounting and accountants is extensive, although much of it fails to emphasize the distinctive nature of accounting--its particular strengths and weaknesses, promise and limits--as compared to

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advancing or otherwise discussing the idea that corporate law moves to the lowest common denominator (the "race to the bottom" literature), see, e.g. Note, *Little Delaware Makes a Bid for the Organization Trust*, 33 AM. L. REV. 418, 418-19 (1899) (describing Delaware as a "little community of truck-farmers and clam-diggers . . . determined to get her little, tiny, sweet, round, baby hand into the grab-bag of sweet things before it is too late."); Louis K. Liggett Co. v. Lee, 288 U.S. 517, 558 (1933) (wherein Justice Brandeis coined the term); E. Merrick Dodd, Jr., *Statutory Developments in Business Corporation Law, 1886-1936*, 50 HARV. L. REV. 27, 57 (1936) ("[T]he states are largely engaged in bidding against one another for the favor of the promoters of corporate enterprises and concern themselves only to a limited extent with the practical consequences to the investor . . ."); John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 773 (1987) (suggesting that federal legislation might provide minimum standards for state takeover law); Melvin Aron Eisenberg, *Bad Arguments in Corporate Law*, 78 GEO. L.J. 1551, 1551 (1989-1990) (arguing that it would be "a fallacy to believe that just because markets are imperfect, mandatory rules would necessarily be better"); LYNN M. LOPUCKI, *COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS* 24 (2005) (arguing that competition among states and resultant forum shopping have negatively impacted bankruptcy law). Cf. Ralph K. Winter, Jr., *Economic Regulation vs. Competition: Ralph Nader and Creeping Capitalism*, 82 YALE L.J. 890, 893 (1972) (arguing that "government by its very nature reacts to political pressure, rather than impartial standards, and one should anticipate that executive or independent agencies will respond most favorably to those with the greatest ability and incentive to organize and press their claims"); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 290 (1977) (concluding that "[a]n expanded federal role in corporate governance would almost surely be counterproductive"); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919 (1982) (arguing that the "race to the bottom" thesis is based on a flawed theory of the firm); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 279 (Autumn, 1985) (showing that "Delaware's success cannot be attributed to the tailoring of its code to the tastes of large corporations"); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 752 (1987) (advocating "a view [that] recognizes that shareholders benefit from state competition, while granting that, on occasion, competition may well produce laws that shareholders in some firms would not choose to adopt voluntarily"); Roberta Romano, *THE GENIUS OF AMERICAN CORPORATE LAW* 1 (1993) (arguing that "[t]he genius of American corporate law is in its federalist organization"); E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 393 (1997) (celebrating the virtues of "state-oriented federalism and . . . flexible self-governance" in American corporate law).

other “gatekeeping” professions. The regulation of the profession introduces a complicated and very political history, and the promulgation of substantive standards can be equally political. Philosophical pragmatism and its influence on Progressivism was important both in providing political arguments to bolster increased roles for CPAs and in providing the epistemological foundation for accounting’s earliest theorists. Thus pragmatism plays a role in the form and substance of accounting through the 1960s.

Newly created oversight bodies have merely duplicated existing (and failing) governance. Accounting’s organization could be improved significantly by either centralizing or decentralizing oversight--that is, by relying on either a top-down or bottom-up governance. But for now I only identify the regulatory problem, leaving its resolution to subsequent work.

Substantively, accounting is inescapably underdeterminate: its standards sometimes, but not always, lead to clear results. Accounting is necessarily subjective and non-scientific, and the rhetoric of “accounting as art” has long played an important role in the profession’s self image and its marketing to the public. Building on this tradition and accounting’s pragmatist roots, along with legal literature on accounting, this article concludes that substantive reforms should incorporate elements of judgment and subjectivity by requiring increased disclosure, but not prescribing specific accounting treatments.

The motivation of this article is twofold: (1) to bring to light the disorderly and ineffective system of governance under which the U.S. accounting profession has developed and exists today; and (2) notwithstanding extensive criticism of the structure of accounting as a profession, to largely defend its evolution of substantive standards, even in light of popular allegations that accounting played a significant role in recent economic turmoil by the adoption of fair value asset valuation. In the course of defending accounting’s substantive posture, however, I also endeavor to disabuse common misconceptions about the nature, utility, and promise of accounting more generally, both within and outside the profession. This article questions the wisdom of retreating from fair value accounting, proposing instead only increased disclosure of the way assets and liabilities are valued, including securities and other items, both physical and intangible. Acknowledging accounting’s limits and re-emphasizing its strengths as compared to other financial “gatekeeping” professions would improve accounting’s image and reputation, and also improve the quality and utility of financial reporting.

This article also makes extensive reference to the December 2008 *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* issued by the Office of the Chief Accountant, Division of Corporation

Finance, U.S. Securities and Exchange Commission.<sup>16</sup> As its clumsy title suggests, the report was written under congressional demand as part of the earliest government intervention of the economic downturn in 2008.<sup>17</sup> The SEC Report is of landmark importance in both its scope and foundation for analyzing the effects of fair value accounting.

Part III of this article questions whether it is possible for accounting to provide the type of accuracy many seem to hope or believe that it can. The notion of objective presentation is certainly consistent with the bean counter caricature, the picture of accountants doing repetitive work requiring little or no exercise of judgment. Yet accounting can also be described as a fundamentally inchoate effort.<sup>18</sup> Even if one were to believe that financial data is wholly objective or factual, one must concede that accounting is necessarily imperfect in its depiction of those underlying facts.<sup>19</sup> One goal of accounting is to provide *timely* information, and that necessarily involves quality trade-offs.<sup>20</sup> The recognition of inherent imperfection between rules and outcomes (or indeterminacy, as in the context of law)<sup>21</sup> has been largely unacknowledged in the contemporary academic literature and policy debates about financial accounting, while it should instead be the lodestar of all discussions about the state and direction of accounting. *Accounting is necessarily imperfect.* This was once well understood and used to underscore the need for accountants' experience and judgment, and to justify their regulatory role.

Fair value accounting is likewise imperfect, but it is not evil. The

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16. 2008 SEC Report, *supra* note 11, at 9.

17. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 133(a), 112 Stat. 3765 (enacted October 3, 2008).

18. *See infra* Part III.A.

19. "To such accounting choices involving professional judgement [sic] there can never be a precisely 'correct' solution." MYDDELTON, *supra* note 7, at 47.

20. To perfectly report the cost of a contingency, for instance, could take years of waiting for the outcome of prolonged litigation. "Even though no loss has yet occurred and so no monetary transaction cognizable under GAAP has transpired, GAAP's principle of conservatism requires that such uncertainties be disclosed in the financial statement . . . . The line item for loss contingencies does not usually state a monetary amount, but instead makes a cross-reference to the footnotes to the financial statements that contain a narrative discussion of the nature of the loss contingencies . . . ." LAWRENCE A. CUNNINGHAM, *INTRODUCTORY ACCOUNTING AND FINANCE FOR LAWYERS* 117 (3d ed. 2002).

21. The indeterminacy debate in law refers to whether competing outcomes resolving a case can be derived from the same body of doctrine--whether law dictates particular outcomes. For a discussion of indeterminacy in a variety of forms, from strong to weak, see Lawrence B. Solum, *On the Indeterminacy Crisis: Critiquing Critical Dogma*, 54 U. CHI. L. REV. 462 (1987). Similar to Solum's conclusions about indeterminacy in law, easy cases in accounting refute the absolute indeterminacy of accounting, yet difficult cases confirm the validity of various weaker formulations of indeterminacy. This issue is discussed in greater detail *infra* Part III.B.i.

history of fair value is extensive,<sup>22</sup> and it is also a story of responding to fair value's alternatives and their problems, both theoretical dilemmas and implementation obstacles.<sup>23</sup> Fair value accounting likely has contributed to some to the world's current economic woes (although the actual amount is widely disputed),<sup>24</sup> but there exists no clearly better alternative waiting in the wings. Fair value also highlights a fundamental schism between "past-oriented, stewardship function" academic accountants and regulators, versus practitioners "continuing to recognize the value-in-use and scorekeeping role of accounting."<sup>25</sup> That depiction of the schism makes accounting seem on the verge of regaining its usefulness in spite of opposition from the elites. But others would frame the same debate as a conflict over "[o]rthodox versus revolutionary accounting."<sup>26</sup> Transparency through disclosure, however, is desirable whether accountants are orthodox stewards or current value revolutionaries.

## II. FORM

Accounting and accountants are often considered gatekeepers of the financial world.<sup>27</sup> "Market participants need to rely with confidence on

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22. Arewa, *supra* note 14, at 67. The industrial revolution brought issues of accounting to the fore. GARY JOHN PREVITS & BARBARA DUBIS MERINO, *A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING* 97-98 (1998). The Gilded Age revived these debates and, years later, the debate became most heated following World War II. *Id.* at 103-74, 305-10.

23. As to alternatives to fair value accounting, while other measurement bases certainly exist, each alternative also exhibits strengths and weaknesses, as well as implementation issues. Considering evidence regarding the usefulness of fair value information to investors, the suspension of fair value accounting to return to historical cost-based measures would likely increase investor uncertainty. However, given the significant challenges encountered in practice related to implementing existing standards, additional actions to improve the application and understanding of fair value requirements are advisable. Such additional measures to improve the application should include addressing the need for additional guidance for determining fair value in inactive markets (including examining the impact of illiquidity), assessing whether the incorporation of credit risk in fair value measurement of liabilities provides useful information to investors, and enhancing existing presentation and disclosure requirements. 2008 SEC Report, *supra* note 11, at 6.

24. *Id.* at 182 n.291 (discussing the lack of "large-scale empirical evidence on the potential pro-cyclical effect of fair value accounting").

25. PREVITS & MERINO, *supra* note 22, at 420.

26. MYDDELTON, *supra* note 7, at 160. See also D. R. Myddelton, *Orthodox versus Revolutionary Accounting*, 3 J. APPL. ACCT. RES. 17, 17 (1996) (explaining the differences between orthodox and revolutionary accounting).

27. "Accountants serve a gate-keeping function." Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1167 (2003); see also JOHN C. COFFEE, *GATEKEEPERS: THE ROLE OF THE PROFESSIONS AND CORPORATE GOVERNANCE* 108 (2006) (noting in Chapter 5 the rise, fall, and redefinition of the auditor from bookkeeper to professional to information consultant).

accountants so that they can have confidence that public company financial statements accurately reflect the financial condition of the companies that issue them. Unfortunately, along with other gatekeepers, the accounting industry failed investors during the 1990s.”<sup>28</sup> Surely accountants have influence over the presentation of financial data, but how are the rules or norms of presentation determined and established? Are they authoritative? Are they flexible enough? Are they *correct*?

Accounting’s relationship to other financial institutions and professions is critical to understanding the effects and importance of its internal structure. Of late, accounting has been portrayed as adversely affecting the rest of the financial world because of accounting’s control over the content of financial reporting and the supposed repercussions of changes in financial statement representations, an effect called “procyclicality.”<sup>29</sup> The actual extent of procyclicality from fair value accounting has been disputed by detailed study,<sup>30</sup> but I do not here dismiss its potential effects.

Beyond procyclicality, accounting’s regulatory framework has long been criticized for its ineffectiveness and complexity.<sup>31</sup> Too many organizations with overlapping jurisdictions, missions, and authority have their hands in accounting, yet avoid taking any responsibility for accounting’s problems. This environment makes the profession especially prone to egregious rent-seeking<sup>32</sup> and further entrenchment of the interests of those with the most power already.<sup>33</sup>

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28. Macey & Sale, *supra* note 27, at 1167.

29. The SEC “refers to the term ‘pro-cyclicality’ generally to mean the amplification of otherwise normal cyclical business fluctuations.” 2008 SEC Report, *supra* note 11, at 182.

30. “The Staff observes that fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008.” 2008 SEC Report, *supra* note 11, at 4. Rather, bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. *Id.* For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed. *Id.*

31. As Justice Kennedy has observed, “[t]here are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question.” *Shalala v. Guernsey*, 514 U.S. 87, 101 (1995).

32. “Some costs [of Sarbanes-Oxley] undoubtedly are deadweight social losses associated with the highly inefficient statute. Another significant portion of the costs, however, reflects wealth transfers from widely dispersed, politically weak shareholders to well-organized, highly concentrated interest groups—like the biggest auditing firms.” JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* 163-64 (2008).

33. Macey & Sale, *supra* note 27, at 1176-77 (arguing that the overwhelming concentration of attestation work for SEC-registrants with only four accounting firms is a significant contributor to the commodification and devaluation of audits).



*A. Procyclicality and Accounting's Relation to Financial Markets*

Part of the magnitude of the current financial crisis may well be a result of “procyclicality,”<sup>34</sup> which refers to financial policies that magnify the impact of fluctuations or problems.<sup>35</sup> Although procyclicality may be part of the *scale* of what is going on now, initially in financial markets and later repercurring throughout the economy, procyclicality does not explain the underlying problem--valuation--at all.<sup>36</sup> Fair value accounting was previously championed to fight against the overvaluation of large assets on the books under historical cost valuation. Of course, now we are seeing the dark side of fair value in the devastating downward adjustments affecting some firms.<sup>37</sup>

Even by late 2007, securitized loans started becoming “toxic assets”<sup>38</sup> nobody was willing to touch--in part because there was an expectation of the federal government stepping in, as has since happened.<sup>39</sup> Investors were reluctant to trade without knowing what the government was going to do and, because everybody was unwilling to buy, the markets for those assets in effect shut down, at least temporarily, although we have yet to see securitized mortgage markets bounce back substantially since the federal government began intervening (through so-called “bailouts”) in September 2008.<sup>40</sup> In the meantime, procyclicality almost certainly did contribute to,

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34. *All's Fair: The Crisis and Fair-value Accounting*, THE ECONOMIST, Sept. 20, 2008, at 92-93.

35. 2008 SEC Report, *supra* note 11, at 182.

36. *All's Fair*, *supra* note 34.

37. *See infra* note 50 and accompanying text.

38. *See* Carrick Mollenkamp, *Did UBS Dump Toxic Assets?*, WALL ST. J., Feb. 27, 2008, at C2, available at <http://online.wsj.com/article/SB120402238986793439.html> (“Together with Merrill and Citigroup Inc., UBS was one of the biggest players in the business of repackaging mortgage bonds into pools known as collateralized debt obligations, or CDOs, and has been among the hardest hit by losses on mortgage investments--more than \$18 billion in 2007.”).

39. *See* Sarah Turner, *Bank Woes Sink European Shares*, WALL ST. J., Sept. 29, 2008, available at <http://online.wsj.com/article/SB122267412972085241.html> (“Investors have been waiting anxiously for details of a \$700 billion U.S. plan to stabilize the financial markets by taking toxic assets off bank balance sheets.”).

40. *See* Posting of Jenny Anderson, Michael J. de la Merced & Eric Dash to The N.Y. Times Dealbook blog, <http://dealbook.blogs.nytimes.com/2008/09/16/federal-reserve-may-act-alone-in-rescuing-aig/> (Sep. 16, 2008, 17:24 EST) (discussing the first bailout that occurred in September 2008 when the federal government made a loan to save insurance giant AIG). Since that time, the amount and scope of federal intervention has continued to grow. Even AIG has continued to receive additional money. *See, e.g.*, Brady Dennis, *AIG Said To Receive Access to More Cash: Insurer Expected to Report Record Loss*, WASH. POST., Mar. 2, 2009, page A01, available at [http://www.washingtonpost.com/wp-dyn/content/article/2009/03/01/AR2009030101218\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2009/03/01/AR2009030101218_pf.html) (“American International Group will gain access to \$30 billion more in taxpayer money as part of another restructuring of its federal bailout, sources involved in the negotiations said [on March 1, 2009].”).

and might even have caused, the drying up of credit markets, making asset-trading increasingly difficult as loans were called after taking accounting write-downs. Even if procyclicality has had a minimal impact in current conditions,<sup>41</sup> it is quite conceivable that it could have greater impact in the future, thus it merits discussion here. Critics say fair value accounting inevitably leads to increased procyclical effects, introducing too much “noise” into financial data.<sup>42</sup>

If the trading price of an asset is zero, many have interpreted FAS 157 to mean that they must also adjust their books to zero for such assets.<sup>43</sup> But are such assets truly worthless? Of course not--and today's financial conditions actually make them potentially attractive investments<sup>44</sup> even though liquidity problems have made such investment exceedingly difficult. No doubt these assets were overvalued in the past, but even risky assets like mortgage-backed securities still have some underlying value, often called fundamental or intrinsic value.<sup>45</sup> After all, they still represent credible claims against debtors, even if some debtors are considerably riskier than others.<sup>46</sup> Taking write-downs to the book value of such assets

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41. See 2008 SEC Report, *supra* note 11, at 43-138 (discussing the impact of fair value accounting on financial institutions, and especially on failed banks, and concluding that the impact was minimal).

42. See *id.* at 141, (quoting comment letter from retired securities analyst Jeffrey B. Cross: “Mark to market, while conceived with the best intentions in mind, causes both too much noise in the system and produces a degree of balance sheet variation wholly inconsistent with orderly markets, as must now be all too obvious.”).

43. See Sorkin, *supra* note 2 (“Sometimes, there is no market--not for toxic investments like collateralized debt obligations, or C.D.O.'s [sic], filled with subprime mortgages. No one will touch this stuff. And if there is no market, FAS 157 says, a bank must mark the investment's value down, possibly all the way to zero.”). This is not, however, the only interpretation of fair value's requirements, nor is it that of the SEC, as will be discussed in greater detail in *infra* Part III.C.ii; see also 2008 SEC Report, *supra* note 11, at 172 (“SFAS No. 157 assigns the highest priority within the fair value hierarchy to quoted prices in active markets for identical assets or liabilities (i.e., Level 1), with multiple permissible valuation techniques (consistent with a market approach, income approach, or cost approach).”).

44. See David P. Goldman, *Fixing the Bank Crisis is the Easy Part*, ASIA TIMES, Jan. 24, 2009, available at [http://www.atimes.com/atimes/Global\\_Economy/KA24Dj02.html](http://www.atimes.com/atimes/Global_Economy/KA24Dj02.html) (“Forced selling by hedge funds has cheapened the price of subprime mortgage bonds, for example, to the point that they are highly attractive. AAA-rated bonds backed by subprime mortgages issued in 2007, for example, start to lose principal only after losses reach 35%. Losses almost certainly will exceed that number--but will they exceed 50%, or 60%? That is extremely unlikely.”).

45. The SEC refers to this as “current value-in-use (e.g., based on discounted expected future cash flows).” See 2008 SEC Report, *supra* note 11, at 177 (noting that fundamental or intrinsic value is often referred to as “current value-in-use”).

46. Often misunderstood or ignored, however, is the fact that “subprime” loans are made bi-modally, both to applicants that cannot qualify for other loans, but also (particularly the largest of the subprime loans) to those who are willing to pay more simply in order to not disclose the source or amount of their incomes to lenders. The latter category includes those who might have plenty of income that may not be regular or readily documentable by

made some firms, *e.g.*, Lehman, unable to get or maintain the credit they needed to operate in the short term. The assets said to be responsible for the “meltdown” simply are not worthless today, and were not worthless in the past. They merely are not worth as much as people were once saying they were.

Who was overvaluing these assets? They were traded primarily by sophisticated institutional investors. The biggest culprits, however, may be the ratings agencies that had implausibly given AA and AAA ratings to these inherently risky securitized mortgages.<sup>47</sup> Jonathan Macey has warned of the crucial, though too often neglected, importance of such financial intermediaries in other corporate governance contexts.<sup>48</sup> We have now but one more devastating example of intermediaries' failures due to their conflict of interests--as is being observed, and blamed on the U.S., by commentators around the world.<sup>49</sup>

The weaknesses of fair value accounting, however, were not unknown as accounting *slowly* transitioned to more of a fair value paradigm. Fair value's rise came about because, in different circumstances, it has the

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sources like a pay stub.

47. Even in 2007 ratings agencies were coming under attack for having given AAA ratings to bonds of subprime mortgage bundles. See Vikas Bajaj, *Rate Agencies Move Toward Downgrading Some Mortgage Bonds*, N.Y. TIMES, July 11, 2007, available at <http://www.nytimes.com/2007/07/11/business/11lend.html> (accurately predicting the coming forced selling of bonds: “Standard & Poor’s, the credit rating firm, said that it would tighten the standards it used to rate bonds backed by subprime mortgages, a tacit acknowledgment that it might have been too optimistic about the housing market . . . . So far, virtually no AAA-rated mortgage bonds have been downgraded. These bonds, which make up about 80 percent of all mortgage securities, are typically protected by several layers of lower-rated bonds like the AAs and BBBs that were acted upon by S.& P. [sic] . . . Still, analysts note that the expectations for losses have been steadily rising and if S.& P.’s [sic] worst case is realized most of the bonds below AA rating will be wiped out. A downgrading of AAA bonds could be significant because it would force large pension funds like Calpers to sell bonds.”).

48. See Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 332 (2003) (“[I]t is not enough that companies make disclosures of financial information. In addition, it is vital that there be set of financial intermediaries, who are at least as competent and sophisticated at receiving, processing, and interpreting financial information (and other information about company performance) as the companies are at delivering it.”).

49. See, *e.g.*, Ashima Goyal, *Reducing Procyclicality*, ECON. TIMES (INDIA TIMES), Jan. 19, 2009, [http://economictimes.indiatimes.com/Comments\\_\\_Analysis/Reducing\\_procyclicality/article\\_show/3998661.cms](http://economictimes.indiatimes.com/Comments__Analysis/Reducing_procyclicality/article_show/3998661.cms) (citing a recent report from India, declaring: “[t]he features that distorted incentives and encouraged excessive risk-taking are now well understood. Among these were procyclical bonuses, securitisation, uniform mark-to-market accounting rules, conflicts of interest for rating agencies, and reliance on risk models based on market prices, so that systemic risk and diversity of views were neglected. Regulation was weakened both in law and in practice.”) (emphasis added).

potential to counteract the problems of alternative accounting methods-- problems that have had very real effects in recent history.<sup>50</sup>

### *B. Accounting's Regulatory Web*

In media reports about financial accounting, small details are often omitted, neglected, or presented misleadingly, even if inadvertently. Accounting regulation is perhaps the murkiest of regulatory backwater, existing and evolving amidst a hodge-podge of governmental, quasi-governmental, and private agencies. Numerous bodies with some common and some opposing interests vie for increased control and influence, even while denying that they have or desire singular power over the profession, or any concomitant responsibility for its actual or perceived failures, such as fair value. Accounting students are taught this very plainly:

#### COMPETING STANDARD SETTING BODIES

As a prominent accountant noted, "the FASB is literally unique: it is a private sector institution performing a public function that is defined in the federal statutes." It is not surprising therefore that the right of the FASB to establish accounting standards continues to be challenged. Some of the major *challenges come not only from outside the profession, but from within as well.*<sup>51</sup>

In a 2008 op-ed in the *Wall Street Journal*, John Berlau of the Competitive Enterprise Institute talked about "Financial Accounting Standard 157, which U.S. regulatory agencies put into effect last November . . . ."<sup>52</sup> Although the SEC did make FAS 157 mandatory for public companies as of November 2007, one would be quite mistaken to take this

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50. Mark to market valuation can be used to fight valuations based on inflated appraisals but also, as we see now, can lead to devaluing assets below their actual value, adding to uncertainty in markets. See Bill Donius, *Mark to Market Accounting--Time Out?*, HUFFINGTON POST, Feb. 2, 2009, [http://www.huffingtonpost.com/bill-donius/mark-to-market-accounting\\_b\\_163371.html](http://www.huffingtonpost.com/bill-donius/mark-to-market-accounting_b_163371.html) ("Mark to Market accounting was ushered in in the 1980's as a solution to the failings of the Savings and Loan Crisis. A few of these big S+L's kept the regulators at bay by carrying big assets (think the Pheonician Hotel) on their books for substantially more than their actual market value, due to inflated appraisals. We find ourselves with the inverse problem today. Banks are having to mark down assets in an uncertain market and thereby being forced to mark them to where the market is today, in a crisis climate. This process becomes a self-fulfilling prophecy as it affects other assets in the class as the market spirals lower. Few buyers know where to enter a downward spiraling market.") (emphasis added). This account does not, however, appreciate the many decades of debate over valuation but remains generally accurate. See generally PREVITS & MERINO, *supra* note 22, at 1-426 (discussing the history of accountancy in the United States).

51. KIESO ET AL., *supra* note 9, at 17 (emphasis added).

52. John Berlau, *Maybe the Banks Are Just Counting Wrong*, WALL ST. J., Sept. 20, 2008, at A15, available at <http://online.wsj.com/article/SB122186515562158671.html>.

to mean that the SEC or any other government agency actually *created* FAS 157, much less that it did so in 2007.<sup>53</sup> FAS documents are not regulatory--not exactly, anyway--and FAS 157 was promulgated not by the SEC in 2007, but by the Financial Accounting Standards Board ("FASB") in September 2006 (after an extended approval process),<sup>54</sup> to take effect "for financial statements issued for fiscal years beginning after November 15, 2007,"<sup>55</sup> thus for calendar year reporters, as of January 2008. Moreover, *FAS 157 did NOT make fair value accounting mandatory; it merely clarified its applicability and use under limited circumstances.*<sup>56</sup> *Rolling back FAS 157 does not repeal fair value accounting, but merely makes its contours more confusing and ambiguous.*<sup>57</sup>

FASB issues all Statements of Financial Accounting Standards ("SFAS" or "FAS"), but FASB is a private association with no inherent legal authority of any kind.<sup>58</sup> Accounting, as a profession, does not have an

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53. Berlau does note that "over the past decade, various mark-to-market accounting rules became part of the official U.S. Generally Accepted Accounting Principles (GAAP), and began to be required by the Securities and Exchange Commission, bank regulatory agencies, credit rating agencies and in the Basel II international framework for measuring bank solvency." *Id.* But even this cursory acknowledgment ignores the much longer history of the debate over valuation, as discussed in *infra* Part III.C.i.

54. See 2008 SEC Report, *supra* note 11, at 157-68, for a detailed description of FASB's process of developing and issuing standards.

55. FIN. ACCT. SERIES, FASB, STATEMENT OF FIN. ACCT. STANDARDS NO. 157, FAIR VALUE MEASUREMENTS, Summary (2006), available at <http://www.fasb.org/pdf/fas157.pdf>.

56. See 2008 SEC Report, *supra* note 11, at 169 ("Overall, suspending SFAS No. 157 would not eliminate fair value accounting. Instead, it would return practice to a state in which fair value accounting exists, but without a consistent framework for determining those measurements.").

57. See *id.* ("[T]he suspension or elimination of SFAS No. 157 would merely remove the application guidance on the measurement of fair value."); see also *id.* at 200-201 ("SFAS No. 157 establishes a common definition of the term fair value for financial reporting and provides for expanded disclosures in cases where preexisting standards require (or in some cases permit) the use of fair value. Accordingly, a suspension of SFAS No. 157 would remove the standardized measurement and disclosure requirements without removing the requirement (or choice) to account for assets or liabilities at fair value. As a result, the suspension of SFAS No. 157 would not reduce the use of fair value as a measurement attribute in financial accounting. Without SFAS No. 157, issuers would return to practices that existed prior to the issuance of the standard. These practices were based on varying definitions of fair value throughout U.S. GAAP and relied upon the limited or conflicting guidance available for applying those definitions. Further, suspending SFAS No. 157 would reduce the comparability and consistency of fair value measurements currently being performed and therefore hinder investors' ability to obtain decision-useful information on a consistent basis from financial statements.") (emphases added).

58. See *id.* at 163 ("The final product of most technical projects [of the FASB] is a SFAS. The SFAS sets forth the final standards, the effective date and method of transition, background information, a brief summary of research done on the project, and the basis for the FASB's conclusions, including the reasons for rejecting significant alternative solutions. It also identifies members of the FASB voting for and against its issuance and includes reasons for any dissents.").

actual “self-regulating organization” (“SRO”).<sup>59</sup> Even in 1999, then-SEC Chair Arthur Levitt asked: “Has the accounting profession become so big and complex that we need a full-time SRO? . . . Is the alphabet soup of regulatory bodies--the POB, the AICPA PEEC, SECPS, ASB and the ISB--really workable?”<sup>60</sup> And that soup has only gotten thicker in the last ten years.

The American Institute of Certified Public Accountants (“AICPA”) is interesting in itself, and it is far from obvious that anyone actually expects the AICPA to self-regulate the profession, or even believes that it *could* do so effectively. Again from 1999:

One of the most important and contentious issues is whether the accounting profession needs a new self-regulatory organization (SRO), and if it does, *whether the AICPA is qualified to fill that role*. Asked by a panel member whether the AICPA could provide the sort of intermediary services typically rendered by an SRO, Levitt replied, “I am skeptical.” He said it was unrealistic to expect the AICPA to focus on an issue that did not concern the bulk of its membership, which is composed largely of firms that don’t audit public companies.<sup>61</sup>

The AICPA in some sense self-regulates the profession of public accounting, as even CPAs who are not AICPA members are frequently bound to follow AICPA rules,<sup>62</sup> even if they work for “non-CPA firms,”<sup>63</sup>

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59. The New York Stock Exchange (“NYSE”) is an example of a self-regulating organization in the financial sector, but self-regulation does not mean absolute control. *See* *Silver v. New York Stock Exchange*, 373 U.S. 341, 361 (1963) (holding that the NYSE was not exempt from antitrust law nor free to deny notice and hearing to those it invoked rules against, even if they were non-members).

60. Robert Tie, *Special Report: Concerns Over Auditing Quality Complicate the Future of Accounting*, J. ACCT., Dec. 1999, available at [http://www.journalofaccountancy.com/Issues/1999/Dec/news\\_srl](http://www.journalofaccountancy.com/Issues/1999/Dec/news_srl).

61. *Id.* (emphasis added).

62. *See, e.g.*, TENN. COMP. R. & REGS. 0020-3-.02 (2009) (“A licensee shall comply with the AICPA Code of Professional Conduct when these rules are silent on any matter.”). Further, “[a] licensee in the performance of professional services, including those who are not members of the AICPA, shall conform to the independence standards established by the AICPA, and where applicable, the United States Securities and Exchange Commission, the General Accounting Office and other regulatory or professional standards setting bodies.” *Id.* at § 0020-3-.03.

63. AICPA, Code of Prof’l Conduct And Bylaws ET § 591 (2008), [http://www.aicpa.org/download/about/Code\\_of\\_ConductBylaws.pdf](http://www.aicpa.org/download/about/Code_of_ConductBylaws.pdf) [hereinafter AICPA Code and Bylaws]. The AICPA Code and Bylaws note:

3. Employment by Non-CPA Firm

.005 *Question*--A member is considering employment with a public accounting firm made up of one or more non-CPA practitioners. If he is employed by such a firm, what are his responsibilities under the Rules of Conduct?

.006 *Answer*--A member so employed must comply with all the Rules of

or outside of public accounting.<sup>64</sup> Even breaches of AICPA rules by non-CPAs associated with them may create liability for members.<sup>65</sup>

The AICPA, however, makes rules about the *profession*; they generally do not create substantive accounting standards in the same way (or at least not to the same degree) FASB does. Yet CPAs are licensed not by the AICPA or FASB, but by individual states and are thus ostensibly subject primarily to state regulators, not to national associations or federal regulators. But neither are the state licensing boards an absolute or ultimate authority, for they are themselves deeply intertwined with other interests and organizations. If the state boards are licensing members of a national profession--but have little control over standards--then it is unclear why the duplicative structures of AICPA, the National Association of State Boards of Accountancy (NASBA), and independent state boards exist. Individual CPAs are not required to be AICPA members, and they cannot be members of NASBA, whose only members are institutional (the state boards).<sup>66</sup> The only mandatory interaction between a CPA and a governing

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Conduct. If he becomes a partner in such a firm, he will then in addition be held responsible for compliance with the Rules of Conduct by all persons associated with him.

*Id.* (emphasis omitted).

64. *See id.* at *Introduction: Composition, Applicability, and Compliance* ("The Code of Professional Conduct was adopted by the membership to provide guidance and rules to all members--those in public practice, in industry, in government, and in education--in the performance of their professional responsibilities.").

65. *See id.* at § 591.263. The AICPA Code and Bylaws note:

141. Responsibility for Non-CPA Partner

.281 *Question*--Is a member who has formed a partnership with a noncertified public accountant ethically responsible for all the acts of the partnership?

.282 *Answer*--Yes. If the noncertified partner should violate the Code, the member would be held accountable.").

*Id.* (emphasis omitted).

66. *See* National Association of State Boards of Accountancy, 2007 ANNUAL REPORT 50 (2007), [http://www.nasba.org/862571B900737CED/BC9B76A2F454CE808625739F005727AE/\\$file/NASBA\\_Annual\\_Report\\_2007.pdf](http://www.nasba.org/862571B900737CED/BC9B76A2F454CE808625739F005727AE/$file/NASBA_Annual_Report_2007.pdf) ("The National Association of State Boards of Accountancy, Inc. (the "Association") is a voluntary membership association of the boards of accountancy (or their equivalent) in the fifty states of the United States, the District of Columbia, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. The Association's assets are limited to use or distribution in accordance with its Articles of Incorporation. The Association's Examination related activities include programs and services related primarily to the testing and licensing of Certified Public Accountants in compliance with the requirements of boards of accountancy. Examination related activities also include the programs and services of Professional Credential Services, Inc. (PCS). PCS is a wholly-owned, for-profit subsidiary that offers testing, including examination development, licensing and certification services to various professions and occupations. Communication programs provide information, facilitate discussion and determine appropriate actions related to issues that concern boards of

body is with the state board, but the state boards largely defer to the guidance of AICPA and NASBA. Why should CPAs not thus be subject directly to NASBA and the AICPA (or just one), instead of to state boards?

Even NASBA's own interests in the licensing and practice of public accounting are complex and multi-faceted, going far beyond serving as a mere association for state regulators. For example, NASBA also earns substantial revenue from a *wholly-owned for-profit subsidiary* that largely controls the Uniform CPA Examination, administered across all U.S. jurisdictions, as well as licensing exams for other professions.<sup>67</sup> The AICPA, however, develops the content and questions for the CPA exam, even while NASBA serves as the "clearinghouse" for the exam.<sup>68</sup>

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accountancy. Also included in these programs are the activities of the NASBA Center for the Public Trust (NCPT), a related nonprofit, public benefit corporation whose mission is to spotlight ethical business practices and to foster the public's trust in American institutions and the professions that serve them. Other programs consist primarily of activities related to assisting boards of accountancy and licensees in identifying quality continuing professional education providers that meet nationally accepted standards for development, presentation, measurement and reporting of educational programs.").

67. *See id.* (stating that the association's activities include testing and licensing of accountants and other professions).

68. *See* UNIF. CPA EXAM CANDIDATE BULL. 1 (2007), [http://www.aicpa.org/download/members/div/career/mini/candidate\\_bulletin\\_200712.pdf](http://www.aicpa.org/download/members/div/career/mini/candidate_bulletin_200712.pdf). The Bulletin states:

#### Examination Partners

The 55 Jurisdictions: The CPA license is issued at the jurisdiction level. To become a CPA, you must be declared eligible for the examination, and subsequently licensed, by the board of accountancy in one of the 55 US jurisdictions. The United States Constitution grants each state or territory the power to regulate the practice of the professions within that jurisdiction's borders. In most jurisdictions, these powers are carried out by a "board of accountancy." These boards of accountancy are made up of appointed individuals and staff (many of whom are CPAs) who are charged with the responsibility of carrying out the laws promulgated by the legislatures and providing an appropriate examination for licensure. The board of accountancy is an administrative agency that handles the day-to-day operations relative to regulating the practice of accountancy including activities involved with entry into the profession. In some cases, the board of accountancy contracts out certain examination-related tasks such as the review of applications and collection of examination fees.

The National Association of State Boards of Accountancy (NASBA): The 55 United States and territorial boards of accountancy are the members of NASBA. NASBA exists to serve its members by providing numerous services that encourage common understanding and practices to promote uniformity across the country to facilitate interstate practice. NASBA takes on the role of a central clearinghouse where all jurisdictions submit information on eligible candidates and from which all jurisdictions receive advisory scores and other examination data.

The American Institute of Certified Public Accountants (AICPA): The AICPA



Who “governs” accounting is really quite ambiguous and, as a result, no organization is willing to take responsibility when things go awry. The SEC and other regulators rarely issue their own rules about accounting.<sup>69</sup> Instead, they typically have occasional mandatory implementation of a specific FASB standard, as in the case of FAS 157. The vast majority of these FAS statements, however, have *not* been explicitly adopted by the SEC, and FASB has no enforcement authority of its own. FASB likewise assures the public it is *not* a regulator, and thus cannot be held accountable for oversight failures.<sup>70</sup> The Public Company Accounting Oversight Board (PCAOB) further confuses matters, as it is a private organization, created by Congress, privately funded by publicly-collected funds, but it also has enforcement authority.<sup>71</sup>

Accounting’s “governance” is more like a web of private and public institutions which influence accounting in different ways, at different times, and with different degrees of overlap. All of them point at each other whenever anything goes wrong.

i. What is Professional Accounting?

CPAs, since their earliest organization as a profession, have struggled to distinguish themselves from bookkeepers and accountants not holding a license. The AICPA offers the public this explanation of the difference:

AREN'T CPAS AND ACCOUNTANTS THE SAME THING?

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is the largest national, professional organization for CPAs. The AICPA provides members with the resources, information and leadership that will enable them to provide valuable services, in the highest professional manner, to benefit the public as well as employers and clients. For the Uniform CPA Examination, the AICPA determines the content of the examination, prepares the examination questions, determines the method of scoring, prepares advisory scores and conducts statistical analyses of examination results.

Prometric: The global leader in technology-enabled testing and assessment services for information technology certification, academic admissions and professional licensure and certifications. Prometric operates a network of computer-based test centers around the world. Among its many clients are the professional licensure examinations for physicians, architects and pharmacists, as well as educational examinations such as the Graduate Record Examination (GRE).

*Id.* (emphases added) (emphases omitted) (footnote omitted).

69. The SEC does, however, continue to restate its authority to do so. See 2008 SEC Report, *supra* note 11, at 16 (“However, despite the Commission’s recognition of the FASB’s financial accounting and reporting standards as ‘generally accepted’ for purposes of the federal securities laws, the Commission retains the authority to require U.S. issuers to apply accounting other than that set by the FASB to ensure compliance with the securities laws and the protection of investors.”).

70. See the discussion of FASB in *infra* Part II.B.vii.

71. See *infra* Part II.B.viii.

All CPAs are accountants but all accountants are not CPAs. In many states, anyone can call himself/herself an “accountant.” In order to become a CPA, almost all states require that an individual meet educational, experience and ethical requirements and pass the Uniform CPA Examination. Only then are individuals granted licenses to practice by state boards of accountancy. Also, only CPAs can perform the mandatory audits of all publicly traded U.S. companies.<sup>72</sup>

Some say that accountants have struggled for the “acknowledgement of the ‘arrival’ of accounting as an important profession, in the same league as law and medicine,” and the tension between CPAs and other accountants certainly does not lessen that struggle.<sup>73</sup>

Accounting encompasses a vast range of professional roles. From clerks and bookkeepers to controllers, CFOs, auditors and consultants, professional accountants fill a large variety of financial positions. Accountants have a wide range of education qualifications (from high school diploma holders through PhDs) and hold a variety of possible licenses or certifications.<sup>74</sup> Accounting and auditing credentials include not only the CPA, but CMA,<sup>75</sup> CFE,<sup>76</sup> and CIA,<sup>77</sup> among many others. There

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72. Am. Inst. of Certified Pub. Acct., *Frequently Asked Questions*, [http://aicpa.org/MediaCenter/FAQs.htm#cpa\\_answer7](http://aicpa.org/MediaCenter/FAQs.htm#cpa_answer7) (last visited Jan. 29, 2010).

73. O'Connor, *supra* note 5, at 755.

74. Originally, even CPAs only needed to have a high school education, but this soon gave way to higher and more formal requirements. PREVITS & MERINO, *supra* note 22, at 198-99, 201. The first PhD in accounting was granted by the University of Illinois in 1939. THOMAS A. KING, MORE THAN A NUMBERS GAME: A BRIEF HISTORY OF ACCOUNTING 90 (2006). The Doctor of Business Administration (“DBA”) is a PhD-equivalent given by some business schools. *Id.* There is currently a large shortage of PhD and DBA qualified accountants, mostly affecting the academic market in business schools, with estimates that less than 50% of the demand for new accounting PhD holders is being met by the supply of graduates. REPORT OF THE AAA/AAPLG AD HOC COMMITTEE TO ASSESS THE SUPPLY AND DEMAND FOR ACCOUNTING PH.D.S, 11, (Am. Acct. Assoc. and The Acct. Programs Leadership Group (2005)), [http://aaahq.org/about/reports/FINAL\\_PhD\\_Report.pdf](http://aaahq.org/about/reports/FINAL_PhD_Report.pdf). The Association to Advance Collegiate Schools of Business (“AACSB”), the primary accrediting body of business schools, places a limit on the percentage of faculty without doctorates, but there is no requirement that any portion of the accounting faculty be licensed, either as CPAs or that they hold any other non-academic accounting credential. PREVITS & MERINO, *supra* note 22, at 342. Until the late 1960s, accounting faculty were allowed to have “a master’s degree with a CPA” in lieu of the terminal doctorate required by other business school faculty, although there were “no substantive changes” to accounting education, which had remained unchanged since the 1930s, that accompanied this move. *Id.*

75. See Inst. of Mgmt. Acct., *Certification Providing You a Pathway to Success*, <http://www.imanet.org/certification.asp> (last visited Jan. 29, 2010) (defining CMA as a Certified Managerial Accountant, administered by the Institute of Management Accountants: “The CMA designation represents a broad business competency and mastery of the management-level skills required to add value, drive business performance, and build quality financial practices within organizations. The program objectively tests and validate [sic] expertise in areas essential to analyzing, managing and evaluating business solutions

are also potential additions to the CPA credential, such as CPA ABV,<sup>78</sup> CITP,<sup>79</sup> CFF,<sup>80</sup> all administered by the AICPA to those who are already CPAs and AICPA members. Beyond these choices, there are also cognate

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that contribute to the success of an organization.”); *see also* PREVITS & MERINO, *supra* note 22, at 412 (discussing the rise and potential threat to CPAs of the CMA credential, which reflects an increase in the stature and maturity of management accounting).

76. *See* Assoc. of Certified Fraud Exam’r, *The CFA Credential*, <http://www.acfe.com/about/cfe-designation.asp> (last visited Jan. 29, 2010) (“The Certified Fraud Examiner (CFE) credential denotes proven expertise in fraud prevention, detection and deterrence. CFEs are trained to identify the warning signs and red flags that indicate evidence of fraud and fraud risk. CFEs around the world help protect the global economy by uncovering fraud and implementing processes to prevent fraud from occurring in the first place.”).

77. *See* The Inst. of Internal Auditors, *Certified Internal Auditor*, <http://www.theiia.org/certification/certified-internal-auditor/> (last visited Jan. 29, 2010) (“The Certified Internal Auditor® (CIA®) designation is the only globally accepted certification for internal auditors and remains the standard by which individuals demonstrate their competency and professionalism in the internal auditing field. Candidates leave the program enriched with educational experience, information, and business tools that can be applied immediately in any organization or business environment.”); *see also* PREVITS & MERINO, *supra* note 22, at 413 (noting that, “[i]nternal auditors’ increasing stature reflects the demand for internal control aspects of corporate operations.”).

78. *See* Amer. Inst. of Certified Pub. Acct., *Mission and Objectives of the ABV Program*, <http://fvs.aicpa.org/Memberships/Mission+and+Objectives+of+the+ABV+Credential+Program.htm> (last visited Jan. 29, 2010) (“The ABV Credential program allows credential holders to brand or position themselves as CPAs who are premier business valuation service providers. ABV Credential holders differentiate themselves by going beyond the core service of reaching a conclusion of value, by also creating value for clients through the strategic application of this analysis.”).

79. *See* Amer. Inst. of Certified Pub. Acct., *Overview of The Certified Information Technology Professional Credential*, <http://infotech.aicpa.org/Memberships/Overview+of+The+Certified+Information+Technology+Professional+Credential.htm> (last visited Jan. 29, 2010) (“A Certified Information Technology Professional (CITP) is a Certified Public Accountant recognized for his or her unique ability to provide business insight by leveraging knowledge of information relationships and supporting technologies. Unlike other certifications that recognize on a wide scope of skills, the CITP credential is an accounting professional that focuses on information assurance and management, making a CPA among the most trusted business advisor.”).

80. *See* Amer. Inst. of Certified Pub. Acct., *Overview of Certified in Financial Forensics (CFF) Credential*, <http://aicpa.org/cff> (last visited Jan. 29, 2010) (“The credential, Certified in Financial Forensics (CFF), combines specialized forensic accounting expertise with the core knowledge and skills that make CPAs among the most trusted business advisers. The CFF encompasses fundamental and specialized forensic accounting skills that CPA practitioners apply in a variety of service areas, including: bankruptcy and insolvency; computer forensics; economic damages; family law; fraud investigations; litigation support; stakeholder disputes and valuations. To qualify, a CPA must be an AICPA member in good standing, have at least five years of experience in practicing accounting, and meet minimum requirements in relevant business experience and continuing professional education.”).

certifications such as CFA,<sup>81</sup> ASA,<sup>82</sup> and securities licenses. Still, the CPA is generally considered the most rigorous and prestigious of accounting credentials. Additionally, CPAs have certain grants of exclusive privilege, such as performing financial statement audits for SEC-registered corporations and, in most states, financial statement audits of any entity.

It is important to keep in mind that “accountants” in the context of publicly-traded corporations regulated by the SEC are but a tiny part of professional accounting, though a segment of great importance.<sup>83</sup> Even most CPAs are not part of this elite subclass of professional accountants.<sup>84</sup> While this article also focuses primarily on this very narrow part of professional accounting, keeping in mind the broader context may go far in explaining why accounting is so heterogeneous in its sources of organization and governance.

The passage of the Securities Act of 1934 “conferred upon CPAs a legally defined social obligation: to assist in creating and sustaining investor confidence in the public capital markets. Accountants now had an acknowledged social obligation that justified their claim to professional status.”<sup>85</sup> For more than seventy years, both the profession and the public it has pledged to serve have struggled to learn the limits and delimit the meaning of this change. During this time, legislation (most notably Sarbanes-Oxley<sup>86</sup>) has occasionally redefined this relationship, and often been very critically received.<sup>87</sup> The endurance of this social obligation

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81. See CFA Institute, The CFA Program, at 3, [https://www.cfainstitute.org/cfaprogram/pdf/cfaprogram\\_brochure.pdf](https://www.cfainstitute.org/cfaprogram/pdf/cfaprogram_brochure.pdf) (last visited Mar. 14, 2010) (“Anchored by a practice-based curriculum, the CFA Program is based on the knowledge identified by professionals as essential to the investment decision-making process. This Candidate Body of Knowledge™ covers 10 general topic areas ranging from equity and fixed-income analysis to portfolio management to corporate finance.”). The ten general topic areas are: Ethical and Professional Standards, Quantitative Methods, Economics, Financial Reporting and Analysis, Corporate Finance, Equity Investments, Fixed Income, Derivatives, Alternative Investments, Portfolio Management, and Wealth Planning. *Id.*

82. Accredited Senior Appraiser certification, administered by the American Society of Appraisers (also “ASA”), is especially attractive to those in financial fields for the credential in business valuation. See Amer. Soc’y of Bus. Appraisers, *Business Valuation*, <http://www.bvappraisers.org/> (last visited Jan. 29, 2010) (providing information on American Society of Appraisers).

83. See Tie, *supra* note 60 (noting that the AICPA’s membership “is composed largely of firms that don’t audit public companies.”).

84. *Id.* (discussing comments by former SEC-chair Arthur Levitt explaining that auditing public companies is “an issue that d[oes] not concern the bulk of [the AICPA’s] membership.”).

85. PREVITS & MERINO, *supra* note 22, at 274.

86. See Sarbanes-Oxley Act of 2002 § 15 U.S.C. 7201 (2002) [hereinafter SOX] (mandating accounting and auditing rules in the wake of the Enron scandal).

87. See e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1521 (2005) (expressing criticism of SOX’s

suggests public accounting still serves an important role, even if its present performance leaves much to be desired.<sup>88</sup>

ii. Licensing: Entry into the Profession of Public Accounting

The Uniform CPA Examination is notorious for its difficulty. Even the famously difficult bar exams of New York and California have majority pass rates.<sup>89</sup> The CPA Exam, however, deliberately maintains very low pass rates, often no more than twenty to thirty percent.<sup>90</sup> Also unlike bar admissions, most states have practice requirements for licensing.<sup>91</sup>

NASBA and the AICPA have a deeply vested interest in keeping tight control, even if jointly, of the CPA exam and the revenue associated with it. The process of merely registering for and taking the exam is rather complicated. The would-be candidate must first choose a jurisdiction; they might or might not have to live in, work in, or have some other tie to that jurisdiction to be a candidate there.<sup>92</sup> In some cases, states offer different credentials: a “certificate” (for those wishing to have certification but not actually practice public accounting) *or* a license (to practice), with somewhat different requirements for each.<sup>93</sup> Although most states retain

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effect on corporate governance).

88. See MACEY, *supra* note 32, at 155 (“Accounting is, in my view, not particularly important to investors, *except to the extent that accounting information is useful in the formation of share prices and in the allocation of economic resources* that share prices facilitate.”) (emphasis added).

89. See Press Release, N.Y. State Bd. of Law Exam’rs (Nov. 13, 2008), <http://www.nybarexam.org/press/1108%20press%20release.pdf> (announcing New York’s July 2008 pass rate of ninety-one percent); Press Release, State Bar Announces Results for July 2008 Cal. Bar Examination (Nov. 21, 2008), *available at* [http://www.calbar.ca.gov/state/calbar/calbar\\_generic.jsp?cid=10144&n=94705](http://www.calbar.ca.gov/state/calbar/calbar_generic.jsp?cid=10144&n=94705) (noting that in California, first-time takers of the bar exam in July 2008 had a seventy-five percent pass rate).

90. See AM. INST. OF CERTIFIED PUB. ACCT., THE UNIFORM CPA EXAMINATION ALERT, WINTER/SPRING (2008), <http://www.cpa-exam.org/alerts/download/cpaalertwinterspring08.pdf> (explaining that the Exam is no longer said to be “curved” since it is now administered by computer). Results, however, are “psychometrically adjusted” to maintain the desired pass/failure rate. Because the examination can be taken one to four sections at a time, *i.e.*, within one quarter, it is difficult to compare pass rates. *Id.* Even for candidates taking just one section, though, there is a majority failure. *Id.* For candidates taking multiple sections in one quarter, single section pass rates range from 15.4-26.3% and complete failure averages more than forty percent. *Id.*

91. See Am. Inst. of Certified Pub. Acct., *CPA Certificate and Permit to Practice Requirements*, [http://www.aicpa.org/download/states/require\\_pract.pdf](http://www.aicpa.org/download/states/require_pract.pdf) (providing a summary of these and other practice requirements by jurisdiction).

92. See Am. Inst. of Certified Pub. Acct., *supra* note 91 (describing the process for registering for the CPA exam).

93. See *id.* (describing the different credentials available for interested accountants).

some sort of experience requirement, the nature, duration, and exemptions for experience vary substantially.<sup>94</sup> The push to establish and extend minimum experience requirements began prior to World War I,<sup>95</sup> although experience requirements are generally being relaxed somewhat today.<sup>96</sup>

Every jurisdiction also maintains its own educational requirements to qualify as a candidate; most states now require 150 semester-hours of college credit,<sup>97</sup> an amount that approaches (or even reaches in many programs) the minimum number of credit hours to earn a master's degree.<sup>98</sup> Debate over the nature of modern accounting education, however, also dates back substantially:

The "first" accountants, who reached maturity and position by 1900, believed in the concept of broad, general, and liberal education. The accounting educators of the next generation were influenced by John Dewey and his followers, who stressed practicality and relevance. Unfortunately, "progressive" education became interpreted to mean a kind of vocationalism with little sympathy or use for so-called classical subjects.<sup>99</sup>

Today's debates and disagreements about educating future CPAs, including the push for professional (post-graduate) accounting schools,<sup>100</sup> merely echo longstanding disagreements.

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94. *See id.* (noting the variance in experience requirements amongst the states).

95. *See* PREVITS & MERINO, *supra* note 22, at 201 (narrating the rise of experience requirements).

96. *See* Am. Inst. of Certified Pub. Acct., *supra* note 91 (commenting that most states now require only one year of public accounting experience, although the specific requirements vary significantly).

97. *See id.* (describing the majority of states' use of the 150 hour requirement).

98. Many accounting programs have, in response, fully integrated their undergraduate and graduate programs to ensure that students wishing to do so may complete both a bachelor's and master's degree in five years. This increase in education requirements is commonly called the "150-hour rule" or the "fifth-year rule" and has received almost universal enactment. Florida was the first state to adopt the 150-hour rule, effective August 1, 1983, and saw a dramatic rise in the number of master's degrees, and also in the funding for them, through both college- and employer-based initiatives. John Cumming & Larry J., Rankin, *150 Hours: A Look Back*, J. ACCOUNTANCY (April 1999), available at <http://www.journalofaccountancy.com/Issues/1999/Apr/cumming.htm>. Some have seen this as a favorable development: "Students get a 'value-added' master's degree--they and their firms will find this adds up to more over the years than just a mere accumulation of 30 additional hours." *Id.* Though, this rule has also come under increasing scrutiny. According to some, the supply of master's degrees greatly exceeded demand from public accounting employers even before the widespread enactment of 150-hour rule requirements, with a supply of master's degrees at 265% that of the demand by 1994. Paul B. W. Miller, *The Five-Year Program Debate Continues: An Updated Analysis of the Supply of and Demand for Master's Degrees in Accounting*, 18 ISSUES IN ACCT. EDUCATION 211 (2003).

99. PREVITS & MERINO, *supra* note 22, at 200-01.

100. *See id.* at 201 (describing the disagreements over the education requirements for future CPAs).

In part, criticism of the fifth year of education stems from the fact that the vast majority of these 150 hours can be in any subject from an accredited school, with most states only requiring twenty four to thirty hours of credit in accounting.<sup>101</sup> Of course, some would laud a requirement for a “full course in general subjects, followed by post graduate work in accounting.”<sup>102</sup> This remains the model at many elite private universities in the U.S., with the undergraduate accounting programs at the University of Pennsylvania’s Wharton School and New York University’s Stern School notable (but also historical) exceptions. Wharton was, in 1883, the first to develop and offer “what would be a sustained accounting course series at the collegiate level,” only two years after the school opened.<sup>103</sup> Along with Wharton, the University of Chicago, Dartmouth, and New York University “provided important first steps in collegiate education in accounting.”<sup>104</sup> A century ago, “educating investment bankers was the preserve of the Ivy League, while accounting education was largely a Big Ten production,”<sup>105</sup> and this may continue to be true today. State schools, as well as less elite private universities, produce the vast majority of CPAs, mostly graduates of their undergraduate--and, increasingly, integrated master’s--programs.

This difficult path to gaining a public accounting license is intimidating and discourages many. Perhaps, though, it is appropriate that candidates learn early on, before even getting their licenses, that they will have obligations to a variety of organizations, for the examination process only foreshadows the complex structure of accounting they will face as practitioners.

### iii. The Regulators: Public and Private, Formal and Informal

Although the fifty-five U.S. jurisdictions (including the fifty states, the District of Columbia, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands) all require an identical licensing exam for CPAs, they maintain individual licensing requirements in addition to the exam.<sup>106</sup> State boards, which issue all public accounting licenses, also govern the other responsibilities affecting the entire career of a CPA, including Continuing Professional Education (“CPE”) requirements, CPA discipline, and firm licensing.

The state boards, however, are heavily dependent upon two private

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101. See Am. Inst. of Certified Pub. Acct., *supra* note 91 (noting that the 150 hour requirement does not require those hours to be in accounting subjects).

102. PREVITS & MERINO, *supra* note 22, at 201.

103. *Id.* at 151.

104. *Id.* at 152.

105. KING, *supra* note 74, at 90.

106. See NASBA, *supra* note 66, at 50 (noting the divergent licensing requirements amongst the states).

organizations, NASBA and AICPA, for the administration of the credentialing process as well as development of professional standards for those already licensed. State boards are concerned, almost exclusively, with the membership, *i.e.*, licensing, of the profession, not substantive accounting positions. As a result, the *only required* association of a CPA with a governing body is as licensee of the state, yet state boards have no appreciable impact or influence on the substantive debates in accounting. This contrasts starkly with law, where attorneys are admitted to the bar of particular courts, which are also the ultimate arbiters of state law. Accounting has no analogous structure to a state court system, thus state licensing becomes purely administrative in nature, wholly detached from the substantive aspects of the profession.

On the surface, NASBA might seem like little more than something of a trade association for state regulatory bodies. NASBA's actual influence, though, is far greater. In addition to serving as the "clearinghouse" for all exam-related activities,<sup>107</sup> NASBA also has a wholly-owned for-profit subsidiary, Professional Credential Services (PCS),<sup>108</sup> which "was established in 1998 . . . to further expand service opportunities developed through NASBA's CPA Examination Services Division into non-accounting disciplines."<sup>109</sup> Through PCS, NASBA provides services to professions including tattooing, body piercing, cosmetology, and auctioneering, and provides examination services in twelve states to ninety-three different professions and occupations and several national associations.<sup>110</sup>

More closely related to its mission, NASBA also has a substantial role in CPE. NASBA does not directly offer many CPE courses, but it does accredit providers. NASBA accreditation is not mandatory for CPE providers, but it does make any courses offered by an accredited provider automatically eligible for credit in every jurisdiction. States also independently certify CPE providers or individual courses, particularly where the provider is not regularly serving large numbers of CPAs from multiple jurisdictions. One small movement away from NASBA's

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107. *See supra* notes **Error! Bookmark not defined.**-96 and accompanying text (discussing the credentialing process for accountants).

108. *See* NASBA, *supra* note 66, at 50 (describing the Professional Credential Services).

109. Professional Credential Services, *About Us*, <http://www.pcsdq.com/pcsweb/pcspages.nsf/LKL/BEC8D13A22843E0B86256C76006AE61E?OpenDocument> (last visited Jan. 28, 2010).

110. *Id.* ("PCS is headquartered in Nashville, Tennessee and currently provides clients exceptional performance in the delivery of services in the professions of engineering, land surveying, geology, landscape architecture, tattooing and body piercing, cosmetology, barbering, chiropractic, nursing home administration, funeral services, occupational therapy, professional planning, nursing, pharmacy, waste water management, veterinary medicine, psychology, auctioneering, fire protection, radiology, interior design and podiatry.").



influence on CPE, however, has been the recent state-specific ethics requirements (2 of approximately 40 hours of CPE required annually), courses which are only certified by state boards, not NASBA.

In addition to all of these other interests and activities, however, NASBA also purports to be something of a watchdog, through the "NASBA Center for the Public Trust ('NCPT'), a related nonprofit, public benefit corporation whose mission is to spotlight ethical business practices and to foster the public's trust in American institutions and the professions that serve them."<sup>111</sup> One must wonder, though, if a group so invested in the interests of the profession's regulation can be an effective source of oversight.

The AICPA is a voluntary association CPAs may, but are not required to, join. However, all CPAs, whether AICPA members or not, are potentially subject to certain of the AICPA's rules, most importantly, the Code of Professional Ethics. Accounting firms, too, can be members of the AICPA, but firms may only use the phrase "members of the AICPA" if all CPA-owners of the firm are individual members of the AICPA.

AICPA's mission is to "provide members with the resources, information, and leadership that enable them to provide valuable services in the highest professional manner to benefit the public as well as employers and clients."<sup>112</sup> Considering the AICPA's formal role in the development of the Uniform CPA Exam, the AICPA has a tremendous influence on entry into the profession. The AICPA "determines the content of the examination, prepares the examination questions, determines the method of scoring, prepares advisory scores and conducts statistical analyses of examination results."<sup>113</sup> AICPA passes these "advisory scores" on to NASBA, which forwards them on to the state boards, which issue final score reports.<sup>114</sup> The AICPA's influence over entry into the profession of public accounting affects all CPA applicants, regardless of whether or not they are, or ever become, members of the AICPA.

Notwithstanding its lack of formal regulatory authority or full membership by the body of practitioners, the AICPA remains the primary standard-setting body for rules governing the profession through the almost universal adoption of the AICPA Code of Professional Conduct by the licensing jurisdictions. The widespread adoption of AICPA's code has given the body an imprimatur of authority that it had long-struggled to

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111. 2007 NASBA ANNUAL REPORT, *supra* note 66, at 50.

112. The American Institute of Certified Public Accountants, Mission Statement, <http://aicpa.org/About+the+AICPA/AICPA+Mission/>.

113. THE UNIFORM CPA EXAM CANDIDATE BULLETIN, *supra* note 68, at 1.

114. "When advisory scores become available, the AICPA forwards them to NASBA for processing, which involves matching the scores to individual candidates. NASBA then forwards the scores to boards of accountancy for approval and subsequent release to candidates." *Id.* at 18.

obtain.<sup>115</sup> After the American Association of Public Accountants (AICPA's predecessor<sup>116</sup>) first promulgated formal ethical standards in 1907,<sup>117</sup> it faced numerous obstacles: (1) opposition from within the profession;<sup>118</sup> (2) "external criticism from those who thought CPAs were trying to create a monopoly by stifling competition;"<sup>119</sup> (3) "the *lack of power* vested in the national body"<sup>120</sup>; (4) a lack of enforcement capability, even indirectly, by publicizing its sanctions against members;<sup>121</sup> and (5) vast criticism of the vagueness of the "wide latitude in condemning actions"<sup>122</sup> under the power

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115. Even today, the AICPA is cautious in the way it describes its authority: "*Compliance with the Code of Professional Conduct, as with all standards in an open society, depends primarily on members' understanding and voluntary actions, secondarily on reinforcement by peers and public opinion, and ultimately on disciplinary proceedings, when necessary, against members who fail to comply with the Rules.*" The American Institute of Certified Public Accountants, CODE OF PROFESSIONAL CONDUCT AND BYLAWS 4269 (2008), [http://www.aicpa.org/download/about/Code\\_of\\_ConductBylaws.pdf](http://www.aicpa.org/download/about/Code_of_ConductBylaws.pdf) (emphasis added).

116. PREVITS & MERINO, *supra* note 22, at 138 (after several reorganizations and mergers, AIPA ultimately became the AICPA); *see also* The American Institute of Certified Public Accountants, History of the AICPA, <http://www.aicpa.org/About+the+AICPA/Understanding+the+Organization/History+of+the+AICPA.htm> (AICPA and its predecessors have history dating back to 1887, when AIPA was formed).

117. PREVITS & MERINO, *supra* note 22, at 203, 206.

118. *Id.* at 203.

119. *Id.*

120. *Id.* (emphasis added). "No one body had the power to mandate compliance with professional standards, a problem that was equally perplexing in early efforts to develop a conceptual framework for the discipline." *Id.* at 206.

121. *Id.* Previts and Merino note:

Unfortunately, the only power that the institute might have had—publicity—was unavailable. There has always been a strong tendency among professionals for "guild selfishness" and "group bias." Within the national organization, a very influential group believed that accountants should not censure their colleagues. A concession made to these opponents of self-policing, which many considered unwise but unfortunately necessary, was that the names of persons or firms found guilty of professional misconduct not be published in the *Journal*. Only the facts of the case and its determination would be reported.

*Id.* This, however, is no longer the norm, and the AICPA regularly publishes the outcomes of disciplinary proceeding, in accordance with their bylaws:

Notice of disciplinary action pursuant to section 7.3 or 7.4 or of termination of enrollment of a member or a member's firm in an Institute-approved practice-monitoring program, together with a statement of the reasons therefore, shall be published in such form and manner as the Council may prescribe. Council also may prescribe any additional disclosures regarding any matter within the jurisdiction of the professional ethics executive committee.

The American Institute of Certified Public Accountants, Bylaws Section 760.01, [http://www.aicpa.org/About/bylaws/sec700/bl\\_760.html](http://www.aicpa.org/About/bylaws/sec700/bl_760.html).

122. PREVITS & MERINO, *supra* note 22, at 206.

to find members “guilty of an act discreditable to the profession.”<sup>123</sup> In some form, all of these criticisms continue to plague the organization today.

If the AICPA largely does not make substantive standards, though, who does? Although the SEC has statutory authority to set accounting standards, it rarely does so, relying instead on private bodies, typically the Financial Accounting Standards Board. This policy of relying on “independent” standards bodies is not new, even if it remains controversial: “[W]hile academics continue to argue the propriety of the SEC’s de facto delegation of standard setting to the private sector in ASR [Accounting Series Release] No. 4 (1938) and No. 150 (1973), the process has been long accepted but continually challenged.”<sup>124</sup> And even the SEC has acknowledged the need to clarify the relationship and roles of FASB and the SEC “regarding the issuance of interpretive and/or implementation accounting guidance to avoid overlap and potential confusion by constituents.”<sup>125</sup>

From its founding, the actual regulators of accounting came from within the ranks of the regulated:

The establishment of the SEC in 1934 had initially sent tremors through the financial community, but the concern of the business sector diminished significantly when Roosevelt named Joseph P. Kennedy as the first chairman of the SEC. Kennedy’s appointment was considered acceptable to the financial community because he was “one of their own.” Reformers lamented the choice, so typical of Roosevelt, who sponsored reform and then modified its impact by making conciliatory appointments.”<sup>126</sup>

This blurring between the regulators and the regulated has dogged financial regulation from its origins through today.

Government regulation is also highly segmented. Instead of being generally applicable, SEC accounting standards apply only to those falling under its specific regulatory authority, *i.e.*, publicly traded corporations, and this is, more precisely, part of Regulatory Accounting Principles (“RAP”).<sup>127</sup> RAP, however, is not solely a creation of the SEC, but of many government agencies.<sup>128</sup> Generally Accepted Accounting Principles (“GAAP”), promulgated by private FASB, is *generally* accepted, not just by SEC-registrants but also (though less rigidly) by privately-held entities.

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123. *Id.* at 206.

124. *Id.* at 274.

125. 2008 SEC Report, *supra* note 11, at 167.

126. PREVITS & MERINO, *supra* note 22, at 274.

127. *Id.* at 375.

128. *Id.* at 374-75.

Within five years of its creation, the SEC had formally delegated its accounting standard setting authority primarily to two private organizations: the Committee on Accounting Procedure (“CAP”) and the Accounting Principles Board (“APB”).<sup>129</sup> Inflation before, during, and following World War II “had eroded the usefulness of accounting numbers,” yet the CAP and the SEC continued to insist upon historical cost accounting.<sup>130</sup> This dogmatism was not without a high political price, however. Both the CAP and APB would soon be replaced as the SEC’s source of standard setters due, “in part, to the failure of the profession to appreciate the extent to which both income determination and standard setting had become politicized.”<sup>131</sup>

The FASB is part of the Financial Accounting Foundation (“FAF”), a private association created in 1972 to be the independent standard setter for accounting in the U.S.<sup>132</sup> Over the years, FASB’s role has evolved into a quasi-regulatory body, creating standards adopted not only by the SEC but also other regulators.<sup>133</sup> Moreover, Sarbanes-Oxley was written in such a way that FASB qualified as the primary oversight body for accounting under the new legislation *without any changes to its operations*.<sup>134</sup>

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129. Accounting Series Release (“ASR”) No. 4 (April 25, 1938); PREVITS & MERINO, *supra* note 22, at 276.

130. *Id.* at 305.

131. *Id.* at 303-04.

132. The Financial Accounting Foundation provides an overview of the organization on its website:

Organized in 1972, the Financial Accounting Foundation (FAF) is the independent, private-sector organization with responsibility for:

Establishing and improving financial accounting and reporting standards;

Educating constituents about those standards;

The oversight, administration, and finances of its standard-setting Boards, the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB), and their Advisory Councils;

Selecting the members of the standard-setting Boards and Advisory Councils; and

Protecting the independence and integrity of the standard-setting process.

Financial Accounting Foundation, FAF Overview, [http://fasb.org/faf/faf\\_info.shtml](http://fasb.org/faf/faf_info.shtml) (emphasis omitted).

133. FASB’s “Conceptual Framework,” developed in the 1970s and 1980s, had a profound influence on U.K. and IASC regulators, too, both of which “more or less followed its conclusions” in 1999 and 1989, respectively. MYDDELTON, *supra* note 7, at 37.

134. SOX § 108 discusses the formulation and recognition of accounting standards, and amends parts of the Securities Act of 1933, in part as follows:

“(b) Recognition of Accounting Standards.—

“(1) In General.—In carrying out its authority under subsection (a) and under section 13(b) of the Securities Exchange Act of 1934, the Commission may recognize, as ‘generally accepted’ for purposes of the securities laws, any

Interestingly, this parallels the fact that Sarbanes-Oxley's board independence standards established in 2003 only created requirements to compose a board of directors *exactly* as Enron's looked when it was celebrated as among the best in 2000, just a year before its collapse.<sup>135</sup> Just like board requirements, accounting oversight requirements enacted over the past few years may be more rhetoric to keep and expand the power of the hegemony than they are genuine reform.<sup>136</sup>

Although a private organization, FASB's parent, FAF, has both private and public arms: FASB and the Governmental Accounting Standards Board ("GASB"). Thus, a private body not only sets the accounting standards for private businesses, often eventually adopted by a government regulator, but also formulates the standards applicable to accounting by governmental bodies.<sup>137</sup> In a federalist system,

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accounting principles established by a standard setting body—

“(A) that—

“(i) is organized as a private entity;

“(ii) has, for administrative and operational purposes, a board of trustees (or equivalent body) serving in the public interest, the majority of whom are not, concurrent with their service on such board, and have not been during the 2-year period preceding such service, associated persons of any registered public accounting firm;

“(iii) is funded as provided in section 109 of the Sarbanes-Oxley Act of 2002;

“(iv) has adopted procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices; and

“(v) considers, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors; and

“(B) that the Commission determines has the capacity to assist the Commission in fulfilling the requirements of subsection (a) and section 13(b) of the Securities Exchange Act of 1934, because, at a minimum, the standard setting body is capable of improving the accuracy and effectiveness of financial reporting and the protection of investors under the securities laws.

Sarbanes-Oxley Act of 2002 § 108, 15 U.S.C. § 7218. These changes, however, have not affected pre-existing FASB's role, and it has continued as the standard setter for the industry.

135. MACEY, *supra* note 32, at 79, 81; *see also* Sarbanes-Oxley Act of 2002 § 301.

136. SOX, for instance, has increased annual compliance costs by approximately \$2 million per company. MACEY, *supra* note 32, at 97. The total estimated cost approximates \$1.4 trillion and “[s]ome costs undoubtedly are deadweight social losses associated with the highly inefficient statute,” including redistribution from “politically weak shareholders to well-organized, highly concentrated interest groups—like the biggest auditing firms.” *Id.* at 163-64.

137. GASB applies to all government accounting, including state and local governments, along with municipal business, such as airports, but also has some overlap with sister

intergovernmental competition in financial and corporate matters may be an important and valuable feature.<sup>138</sup> On the other hand, it is not clear that the FAF is not, to borrow a Federalist term, a “faction” itself.<sup>139</sup> Additionally, by virtue of its privileged status with the SEC, FASB has no real competitor, nor do states or other organizations promulgate comprehensive standards sufficient to offer an alternative to FASB-centered GAAP, even for use by companies that are not SEC-regulated.

FASB’s links to the profession of public accounting, like the other organizations discussed here, are very strong, despite the fact that FASB affects accounting far beyond the scope of practicing public accountants or publicly traded firms. FASB promulgates GAAP, and GAAP is the law of the land for all of accounting.<sup>140</sup> Before FASB’s creation in 1973, GAAP came mostly from the AICPA<sup>141</sup> and, together, FASB and (to a lesser extent) the AICPA continue to develop GAAP, under explicit sanction by the SEC.<sup>142</sup> Other sources of GAAP are sometimes important, but their role is increasingly minimal, particularly in light of the new codification of GAAP.<sup>143</sup> Although FASB works, to a limited degree, with other institutions,<sup>144</sup> its relationship is clearly centered on cooperating with the

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FASB’s jurisdiction, such as accounting at universities and other non-profits. PREVITS & MERINO, *supra* note 22, at 403, 408. The federal government also has an agency, the Government Accountability Office (GAO), which works more closely with federal government departments and agencies in accounting, as well as broader issues of public “accountability.” *Id.* at 409-10.

138. See generally ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES* 172 (2002) (arguing that competition among governing agencies serves the same functions as our federalist government structure).

139. “By a faction, I understand a number of citizens, whether amounting to a majority or minority of the whole, who are united and actuated by some common impulse of passion, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interests of the community.” *THE FEDERALIST* NO. 10 (James Madison).

140. As the “chief legal authority having jurisdiction over accounting rules and practice . . . the SEC has adopted a strong deferential stance towards the rulemaking power of FASB and tends to sanction, *as a matter of law*, the GAAP rules FASB promulgates.” CUNNINGHAM, *supra* note 20, at 6 (emphasis added).

141. *Id.* at 5.

142. *Id.* at 6.

143. See generally Bruce Pounder, *Framing the Future: A First Look at FASB’s GAAP Codification*, J. ACCOUNTANCY, May 2008, <http://www.journalofaccountancy.com/Issues/2008/May/FramingtheFuture.htm> (providing an overview of the codification project and its implications).

144. For instance, trustee nominations come from a variety of sources and backgrounds:

#### Trustees

The Foundation’s Board of Trustees is an independent body of leaders in their professions with diverse backgrounds and expertise in areas of business, finance, investment, accounting, government, investor advocacy, education, and other professions involved in the activities of the financial and capital markets. The Board is currently comprised of 16 members and, other than the chairman,

AICPA, SEC, and, more recently, the PCAOB.

The PCAOB (often pronounced by transposing the last two letters and being generally freewheeling, phonetically, to say "peek-a-boo")<sup>145</sup> further muddies things. PCAOB is the newest national accounting body in the U.S. It was created as part of Sarbanes-Oxley's accounting reforms in the wake of Enron and other accounting scandals in the late 1990s and early 2000s. It too has been criticized as part of "[t]he mad rush to pass Sarbox in 2002 [which] was less about keeping business honest than it was about keeping Congressmen in office."<sup>146</sup> If PCAOB were an actual government agency, Sarbanes-Oxley would be PCAOB's "organic statute," although it is doubtful that term applies since PCAOB is not actually a federal administrative agency. PCAOB is not part of the government, but a *private non-profit created by congressional charter*. Some have called it a "quasi-private agency,"<sup>147</sup> but it might also be called "quasi-public." It has an enormous amount of regulatory power (hence the "oversight" part of the name) yet remains private, and it is unclear the full extent of PCAOB's overlap, competing or complimentary, with the SEC.

Since PCAOB's creation, it has been engaged in an extensive turf war with the SEC, and the SEC appears to be winning.<sup>148</sup> Still, PCAOB is not part of the SEC or an independent *government* agency (like the SEC),

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Trustees serve a single five-year term and until their successors are elected and qualified. To provide for appropriate continuity of leadership, the Trustee serving in the capacity as chair may be re-elected to successive terms without limitations on the number of terms he or she may serve. The Trustees, in their capacity as the members of the Foundation, have sole authority to elect all Trustees. Three Trustees must have extensive experience as financial officers or as elected officials of state or local governments and candidates for these positions are nominated by the nine governmental organizations that helped form the GASB under the Foundation. Nominations for the remaining at-large Trustee positions are solicited from a broad array of market participants.

Financial Accounting Standards Board, Facts About FASB, <http://www.fasb.org/facts/> (second emphasis added).

145. "Everyone is frustrated with the PCAOB. It certainly doesn't roll off the tongue when spoken as a list of initials; however, I don't want to call it the 'Pi-Cowb.' That's the universal sound effect for a laser gun. Some members of our profession have bestowed upon the PCAOB the far-too-cutesy nickname 'Peek-a-Boo.'" Greg Kyte, *Alphabet Soup*, J. ACCOUNTANCY, Apr. 2009, <http://www.journalofaccountancy.com/Issues/2009/Apr/AlphabetSoup>. See also *Peekaboo Powers*, WALL ST. J., Feb. 8, 2006, at A16, available at <http://online.wsj.com/article/SB113936823813968017.html> (criticizing the scope of powers and alleged constitutional violations of PCAOB).

146. *Id.*

147. *Id.*

148. Although under appeal, in third party litigation between a public interest group and PCAOB, PCAOB and its officers have been deemed "inferior officers," subject to the authority of the SEC. *Free Enter. Fund v. Public Co. Accounting Oversight Bd.*, 537 F.3d 667 (D.C. Cir. 2008).

notwithstanding any control that the SEC might be able to exert over PCAOB, nor is the Board accountable to any part of the executive branch. PCAOB does not report to the attorney general, or even the President, but (at least nominally) reports to the SEC, an independent government agency, even though, “[t]he Board shall not be an agency or establishment of the United States Government. . . . [and no] member or person employed by, or agent for, the Board shall be deemed to be an officer or employee of or agent for the Federal Government by reason of such service.”<sup>149</sup>

While PCAOB is not a government agency, it has been granted enforcement authority and has, in the last several years, already brought disciplinary actions against at least 12 public accounting firms and 19 individuals.<sup>150</sup> The Board has also been mired in controversy with other bodies, including a public interest group’s extensive litigation challenging PCAOB’s constitutionality, a case now granted certiorari before the U.S. Supreme Court.<sup>151</sup>

Whether one wishes accounting to be regulated by the government or not, one should be very concerned about the government in effect outsourcing essential government (regulatory) functions to private organizations directly accountable to no single person or group.<sup>152</sup> It should be of even greater concern when that power includes *criminal*<sup>153</sup> as well as civil actions. The fact that PCAOB appears to have been created explicitly as a “fifth branch” of government, free from democratic accountability, is even more troubling.<sup>154</sup>

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149. Sarbanes-Oxley Act of 2002 § 101(b), 15 U.S.C. 7211 (2002) (emphasis added).

150. Public Company Accounting Oversight Board, Board Actions to Date (Sept. 2008), [http://www.pcaobus.org/About\\_the\\_PCAOB/PCAOB\\_Actions\\_to\\_Date\\_Update.pdf](http://www.pcaobus.org/About_the_PCAOB/PCAOB_Actions_to_Date_Update.pdf) (last visited Jan. 27, 2010).

151. Petition for Writ of Certiorari, *Free Enter. Fund v. Public Co. Accounting Oversight Bd.*, 537 F.3d 667 (2009) (No 08-861), available at <http://law.du.edu/documents/corporate-governance/fev-pcaob/cert-petition.pdf>.

152. See generally Paul R. Verkuil, *Public Law Limitations on Privatization of Government Functions*, 84 N.C. L. REV. 397, 397 (2005-2006) (concluding that certain essential government functions cannot be outsourced to the private market).

153. See Sarbanes-Oxley Act of 2002 § 802, 18 U.S.C. 1519, 1520 (2002) (instituting criminal penalties for alteration of documents).

154. In a Petition for Writ of Certiorari, it was noted:

In creating the Board, Congress deliberately sought to test the outer boundaries of its ability to reduce Presidential power, by establishing a “‘Fifth Branch’ of the Federal Government” . . . over which the President has markedly less control than he exercises over traditional “Fourth Branch” independent agencies like the SEC . . . . As the court below acknowledged, the only reason for this additional diminution of the “level of Presidential control” over executive officers was “Congress’ intention to insulate the Board from partisan forces” that the President (and perhaps Congress) was purportedly able to somehow exert on a traditional independent agency like the SEC. . . . Thus, Congress rejected proposals to lodge the Board’s enforcement function in the SEC . . .



PCAOB, like other bodies, cannot be considered an SRO for public accounting because PCAOB's work is not binding on all accounting or accountants, or even all public accountants, but only the very small portion of CPAs performing *attestation* work for public companies.<sup>155</sup> Moreover, PCAOB's CPA membership is intentionally kept low; thus, to the extent it does regulate the profession, it is not *self*-regulation, *i.e.*, CPAs regulating CPAs. Exactly two of the five members of the PCAOB must be, or have been, CPAs.<sup>156</sup>

Additionally, the cost and efficacy of the PCAOB has been challenged since its inception. PCAOB gets its funding through the SEC, but the SEC ultimately functions merely as a single-payer for PCAOB's budget. PCAOB writes and submits its budgets to the SEC for approval, which assesses and collects fees from publicly traded corporations in order to meet PCAOB's budgetary needs.<sup>157</sup> Thus, a federal agency (the SEC) collects fees from private associations and gives them to another private association (PCAOB), which the SEC *perhaps* supervises, and which performs essential government functions.<sup>158</sup>

To summarize, PCAOB is: (1) a private non-profit; (2) created by Congress; (3) funded by fees assessed on other private (for-profit) organizations, *i.e.*, publicly traded corporations; (4) receives those funds from a government regulatory body; and (5) has been delegated, directly by Congress, federal enforcement authority.<sup>159</sup>

The big question with respect to PCAOB is not "What's wrong?" but "What could possibly be right?" Every bit of PCAOB's mission and power was already part of the existing, if broken and failing, structure of accounting oversight. Sarbanes-Oxley, in creating PCAOB, in no way

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and instead designated the Board a private corporation with the same autonomy from Presidential control as private "self-regulatory-organizations (SROs) . . . such as the New York Stock Exchange," upon which it was explicitly "modeled."

Petition for Writ of Certiorari, *supra* note 151, at 8 (citations omitted).

155. See *supra* notes 58-60 and accompanying text (stating that no SRO currently exists for the accounting profession).

156. Sarbanes-Oxley Act of 2002 § 101(e)(2), 15 U.S.C. 7211 (2002) ("Limitation.-- Two members, and only 2 members, of the Board shall be or have been certified public accountants pursuant to the laws of 1 or more States, provided that, if 1 of those 2 members is the chairperson, he or she may not have been a practicing certified public accountant for at least 5 years prior to his or her appointment to the Board.")

157. Sarbanes-Oxley Act of 2002 § 109(b)-(d), 15 U.S.C. 7219 (2002).

158. See generally PAUL R. VERKUIL, *OUTSOURCING SOVEREIGNTY: WHY PRIVATIZATION OF GOVERNMENT FUNCTIONS THREATENS DEMOCRACY AND WHAT WE CAN DO ABOUT IT* (Cambridge Univ. Press 2007) (arguing that government outsourcing of essential government functions threatens democracy by making such actors unaccountable for their actions).

159. See Sarbanes-Oxley Act of 2002 § 105, 15 U.S.C. 7215 (2002) (outlining investigative authority and disciplinary proceedings for and by board).

remedied any flaws. PCAOB is instead merely duplicative of the existing, and *already inefficient and self-interested*, framework, and this duplication comes at a very high price: a direct cost in excess of \$157 million in 2009.<sup>160</sup>

The mixing of public and private in PCAOB seriously calls into question the ultimate source and nature of PCAOB's authority. Where does PCAOB's authority come from? Can government legitimately delegate authority to non-governmental agencies? Although PCAOB is a private organization, it has been granted the imprimatur of government and law's most explicitly coercive aspect: enforcement, or police power. Put more concretely, the question is over the constitutionality of Congress' giving PCAOB "far reaching executive power while completely stripping the President of the authority to appoint or remove those members or otherwise supervise or control their exercise of that power."<sup>161</sup>

Beyond the U.S., however, there is a growing call for global convergence, not only of accounting standards, but also of oversight. Some have declared that "[o]ur economic world is no longer directed chiefly by geographically defined nations, but by twin transgeographic entities: the multinational corporation and its companion, the institutional portfolio investment fund."<sup>162</sup> A dramatic statement, but such sentiment has led to the call for increasing international convergence. Yet convergence remains a heated and complicated debate.

"The Norwalk Agreement" was the product of a meeting between FASB and IASB in September 2002, in which:

[E]ach acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, both the FASB and IASB pledged to use their best efforts to (a) make their existing financial reporting standards fully compatible as soon as is practicable and (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained.<sup>163</sup>

The SEC has announced formal plans to cooperate with the IASB (International Accounting Standards Board) and, in December 2007, also issued Final Rule 33-8879, allowing financial statements of U.S.-traded foreign firms to be filed in compliance with IASB's International Financial

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160. Public Company Accounting Oversight Board, 2009 PCAOB Budget (2009), [http://pcaob.com/About\\_the\\_PCAOB/Budget\\_Presentations/2009.pdf](http://pcaob.com/About_the_PCAOB/Budget_Presentations/2009.pdf) (last visited Jan. 27, 2010).

161. Petition for Writ of Certiorari, *supra* note 151, at i.

162. PREVITS & MERINO, *supra* note 22, at 362.

163. AICPA and IASB Memorandum of Understanding, <http://www.fasb.org/news/memorandum.pdf> (last visited Jan. 27, 2010).

Reporting Standards (“IFRS”) without reconciliation to U.S. GAAP.<sup>164</sup> NASBA, however, has been increasingly vocal in its opposition to such measures. The FAF and FASB have also been quite critical of the SEC’s planned roadmap for IFRS adoption.<sup>165</sup> More generally, IASB has come under intense pressure to reform its structure from countless groups, including the AICPA and G-20 national leaders.<sup>166</sup> The IASB has responded to this criticism by announcing its plans to increase membership and geographic diversity, as well as establishing a new Monitoring Board.<sup>167</sup>

The problems of accounting’s governance are not unique to the U.S., and international concerns only add to existing disorder. Still, these changes are imminent and must be taken into account as international dynamics already manifest in the U.S. regulatory structure, and this will only increase. In addition to the many interests already described, there are state CPA societies in each jurisdiction lobbying at the state level. There are many additional national accounting organizations other than the AICPA. There is the federal Governmental Accountability Office (“GAO”) which “investigates how the federal government spends taxpayer

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164. See 17 C.F.R. § 210, 230, 239, 249 (2007), available at <http://www.sec.gov/rules/final/2007/33-8879.pdf> (modifying, *inter alia*, Final Rule 33-8879).

165. FASB and its parent organization, the FAF, are calling on the SEC for additional study of “strengths, weaknesses, costs, and benefits of possible approaches” to a U.S. shift to IFRS:

In a 134-page comment letter, the FAF and FASB reaffirmed support for the development of a single set of high-quality global accounting standards but called for a thorough analysis of issues identified by the SEC in its proposed road map as well as other issues outlined in their comment letter. The study should include analysis of possible conversion approaches, the letter states, such as convergence through continuation of the joint standard-setting efforts of FASB and the International Accounting Standards Board (IASB) over a longer period of time, as advocated by some investors and other parties.

*FAF and FASB Call for Additional Study of IFRS Conversion*, J. ACCT., Mar. 13, 2009, <http://www.journalofaccountancy.com/Web/20091542.htm>.

166. See *IASB Oversight Body Responds to Call for Accountability*, J. ACCT., Feb. 3, 2009,

<http://www.journalofaccountancy.com/Web/IASBRespondstoCallforAccountability.htm> (reporting constitutional amendments by the IASB aimed at enhancing public accountability and increased monitoring); *G-20 Addresses Accounting Issues at Financial Summit*, J. ACCOUNTANCY, Nov. 17, 2008, <http://www.journalofaccountancy.com/Web/G20AddressesAccountingIssues.htm> (reporting agreement of G-20 nations on common principles to guide financial market reform and accounting).

167. Press Release, IASC Foundation, *Trustees enhance public accountability through new Monitoring Board, complete first part of Constitution Review*, Jan. 29, 2009, <http://www.iasb.org/NR/rdonlyres/6A31C6E6-423D-4C6D-A18C-D82DFEBE8FD9/0/PRTTrusteesenhancepublicaccountability.pdf>.

dollars,”<sup>168</sup> but is also an agency made up largely of accountants and advises Congress on a wide array of issues. The FTC, CASB, OSHA, IRS, ICC, FCC, DOE, and DOD all “directly interact or influence financial and management accounting practice and policy, thereby shaping the economy and accounting’s environment,” and create Regulatory Accounting Principles (“RAP”).<sup>169</sup> Many more organizations once wielded power and influence but are now defunct.

Beyond the U.S., there is more to international accounting than just the IASB. Most nations have independent standards bodies which work with the IASB to varying degrees. The U.S., however, has traditionally had a great influence on global standards, as “[s]tandard-setters around the world all broadly follow the FASB’s conceptual framework.”<sup>170</sup> One may question, however, how much longer and to what degree this will continue to be true.

There is also proposed legislation in the U.S. to duplicate PCAOB’s model for the standard-setting process.<sup>171</sup> Just as PCAOB monitors CPA firms and companies, the new Financial Accounting Oversight Board (“FAOB”) would monitor the standard setters--primarily FASB, but also the AICPA and other GAAP promulgators.

### *C. Models of Regulation*

One may approach regulation from a variety of perspectives and, particularly in the second half of the twentieth century, regulation has been marked by an exponential increase in cooperation between the regulators and the regulated.<sup>172</sup> This has happened by a variety of means, and has involved both formal and informal cooperation. “Negotiated rulemaking” is the most formal cooperation, where regulators establish venues in which interested parties can discuss the needs for, and effects of, regulations before they are promulgated.<sup>173</sup> In this way, the regulators are still arms of the state, not of the profession, but it is believed that regulation benefits everyone (the regulator, the regulated, and third parties) by allowing increased discussion and cooperation before promulgation, and the final rules are “the product of agreement among representatives of all affected interests at the end of a negotiating process.”<sup>174</sup> However, the presence of interest groups also means increased politicization.

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168. About GAO, <http://www.gao.gov/about/index.html> (last visited Jan. 27, 2010).

169. PREVITS & MERINO, *supra* note 22, at 374-75.

170. MYDDELTON, *supra* note 7, at 119.

171. H.R. 1349, 111th Cong. (2009).

172. See RICHARD J. PIERCE, SIDNEY A. SHAPIRO & PAUL R. VERKUIL, ADMINISTRATIVE LAW AND PROCESS 342-43 (4th ed. 2004) (discussing the rise of negotiated rulemaking).

173. *Id.* at 342-43.

174. *Id.* at 343.

The increasingly political nature of accounting may be troubling, but political pressures emanate from a variety of sources, both public and private. In both the U.S. and the U.K., the government sometimes intervenes directly in accounting through the enactment of law specifying certain actions or standards.<sup>175</sup> More often, governments act through agencies that have the authority to impose rules.<sup>176</sup> In other instances, private bodies serve as standard setters, officially designated so by government regulators, as in the case of the FASB. Private industry, however, can be instrumental in affecting these processes, frequently procuring large benefits by so doing, and undermining the spirit and efficacy of standard setting.<sup>177</sup>

Many recent criticisms point to the “unregulated” or “deregulated” financial industry as being responsible for the current state of the global economy. Such concerns, however, are far from unanimous, with some reminding us that crises are likely to come *notwithstanding the strength and content of regulation*.<sup>178</sup> More importantly, we should be careful about the way in which we characterize regulatory schema. In the modern regulatory context, even famous instances of “deregulation,” *e.g.*, airlines and telephones, are more aptly characterized as “re-regulation” because although the *nature* of the regulation of those industries changed considerably, they certainly did not end up in a state of no regulation.

Both “regulation and deregulation [are] destined to be . . . dynamic process[es].”<sup>179</sup> The mere fact that an industry “is ‘regulated’ . . . does not itself reveal how extensive the regulation is.”<sup>180</sup> Indeed, as Professors Harrison, Morgan, and Verkuil elaborate in their regulation casebook:

[T]he distinction between regulation and deregulation can be [narrow]. For example, when you think of deregulation, it is tempting to assume the government has stepped aside entirely and allowed competitive forces to take over. In fact, a great deal of what legislators call “deregulation” is not that at all. Sometimes, “deregulation” is used to describe situations in which

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175. See MYDDELTON, *supra* note 7, at 104 (citing instances of government interjection into accounting standard development in the U.S. and U.K.).

176. See *id.* at 104 (noting that setting standards for accounting is to some extent a political process that may come from a government agency imposing rules, citing railroad accounting in the U.S. as an example).

177. See *id.* at 104-05 (discussing the treatment of goodwill accounting in the U.K.).

178. See, *e.g.*, Giampaolo Galli and Alberto Mingardi, *Lax Regulation Didn't Cause This Crisis*, WALL ST. J., Jan. 29, 2009, available at <http://online.wsj.com/article/SB123317869729325843.html> (suggesting that “the crisis is, so to speak, regulation-blind, i.e. it wasn't caused by the alleged laxity of U.S. regulators nor would it be necessarily ‘solved’ if we now introduced different rules”).

179. JEFFREY L. HARRISON, THOMAS D. MORGAN & PAUL R. VERKUIL, REGULATION AND DEREGULATION: CASES AND MATERIALS 4 (2d ed. 2004).

180. *Id.*

the pervasiveness of regulation has been reduced. Other times, however, new regulation will be adapted to ease the industry toward competition. Thus, even with more “deregulation,” our economy is likely to continue to be highly regulated. One should be as wary of taking deregulatory efforts at face value as of embracing regulatory proposals.<sup>181</sup>

The absence of *any* type of regulation in a market might be worrisome, but we do not often have to face that because even “unregulated” markets or industries generally give rise to other private bodies that have the interest and power, created by demands of actors in the market, to pressure reform. Thus, we might better describe this state as “market regulation” rather than a *lack* of regulation.

#### i. Market Regulation

Market regulation is founded on the idea that there exist incentives sufficient to stimulate the spontaneous creation of private institutions which will profit from contributing to the regularization, standardization, and rising quality of an industry or profession. In the case of financial markets, public accounting (and, more specifically, auditing) itself emerged as one of these institutions. With the grant of an exclusive government franchise and the mandatory employment of those services though, audits were commodified.<sup>182</sup> When audits were a signal voluntarily provided to attest to quality, their value was quite high. When mandated for all publicly traded firms, however, the audit eventually became a commodity service--a fungible service of less value, no longer providing the same reputational consequences for its providers.<sup>183</sup> Auditing remains, to some degree, a matter of reputation for CPA firms, but “opinion shopping,” premised on the idea that one can *always* find *some* CPA firm willing to give a clean opinion on the financial statements, is rampant.<sup>184</sup>

While financial markets are no longer purely market-regulated (if they ever were), it is possible that certain professions within financial markets

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181. *Id.* at 19.

182. *See* Macey & Sale, *supra* note 27, at 1167 (arguing that modern corporate governance model is flawed due to regulatory commodification).

183. *See id.* at 1167 (“[A]udits no longer serve the economic purpose--providing information that protects investors and leads to efficient pricing of securities--that they once served.”).

184. *See* Dale R. Rietberg, *Auditor Changes and Opinion Shopping – A proposed Solution*, 22 U. MICH. J. L. REFORM 211, 214 (1988) (noting instances of firms changing accounts because of a desire to frustrate the reporting of the true economic substance of the transaction or firm). Of course, some might counter that opinion shopping is not all bad. *See, e.g.,* MYDDELTON, *supra* note 7, at 100 (“But why should the accounting profession resist competition in ideas? In some professions ‘second opinions’ can save lives: should we prohibit opinion-shopping among doctors or barristers?”).

may remain primarily market-regulated. That is, even if a particular regulatory actor is now providing a commoditized service, the rules governing that profession could be provided by the competitive pressures of other actors within or external to the system. In the case of accounting, one could argue that users of financial statements, and institutional investors and other intermediaries in particular, could make effective demand of auditors to ensure adequate financial statement presentation if the SEC had not taken this role.

Chartered Financial Analysts (“CFAs”) are a contemporary example of a market regulatory body. The CFA credential, started in 1963, has become quite prestigious.<sup>185</sup> The CFA charter, however, is not a license, just a signal of one’s competence in financial analysis. The CFA Institute has no government-granted monopoly to provide any sort of service, thus it relies exclusively on its reputation as an organization represented by highly qualified professionals holding the CFA credential around the world. Although CFAs may not audit financial statements, they represent a strong source of competition to many financial services professionals, including CPAs. Despite their increasing prominence, though, CFAs remain a market regulatory institution, operating independently of governments and even self-regulators.

## ii. Self-Regulation

Self-regulation differs from market regulation because the self-regulating industry or profession takes on an affirmative duty to police itself, generally under the threat (implied or explicit) that ineffective self-regulation will prompt government regulation instead.<sup>186</sup> Self-regulation generally occurs through the establishment of an independent group, a self-regulatory organization. The SRO then promulgates its own rules and

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185. Business news has for some years highlighted the increasing importance of the CFA credential. See Louise Story, *Bye, Bye B-School*, N.Y. TIMES, Sept. 16, 2007, at 31 (suggesting that the CFA credential has become more valuable than an MBA); Phil Wahba, *While Ivy League MBAs Impress, Hottest Three Letters Are CFA*, N.Y. SUN, Sept. 26, 2006, available at <http://www.nysun.com/business/while-ivy-league-mbas-impress-hottest-three/42355/> (noting that “[a]t the latest gathering at the New York Society of Security Analysts, the buzz isn’t about getting an Ivy League MBA or taking the CPA examination. It’s the CFA.”). More rigorous research, however, has also suggested that the CFA credential both serves as an effective signal of quality (“credentialism”) and, through the accreditation process itself, actually tends to improve the performance of those who undertake the course of study and examination leading to the charter. Gus De Franco & Yibin Zhou, *The Performance of Analysts with a CFA Designation: The Role of Human-Capital and Signaling Theories*, 84 THE ACCOUNTING REV. 383, 383 (2009).

186. The threat of government regulation if a self regulator does not meet government expectations is sometimes called “enforced self regulation.” HARRISON, MORGAN, & VERKUIL, *supra* note 179, at 495-96.

guidelines, often developing credentials and certifications available to members. SROs may also be, or closely resemble, trade associations, although such a dual mission (both regulating and advancing the interests of the profession) might be thought to erode an SRO's claim of authority and independence as a regulator. Self-regulators, however, may face difficulty in establishing authority where there is not an exclusive right (and therefore control) of holding a professional credential. In accounting, for instance, many practitioners are not and need not be CPAs, thus the AICPA's scope of authority has very complicated boundaries, as discussed earlier.<sup>187</sup>

By the 1930s, self-regulation in accounting shifted from an economic concept to a political one, steeped in the language of political reform.<sup>188</sup> Since that time, accounting has become even further politicized, often advancing the interests of the profession more than proper regulatory objectives.<sup>189</sup> As Jonathan Macey has observed:

“Strangely, the policy debates about accounting tend to confuse concerns about the proper way to *format and package* accounting information with concerns about the actual *content* of information. . . . To a large extent, the obsession with form over substance in American accounting reflects the relative power of the accounting industry.”<sup>190</sup>

Important examples of SROs in today's financial markets are formal securities and commodities exchanges, including the NYSE, NASDAQ, the Chicago Board of Trade, and many others around the world. These markets are independent associations with great autonomy over their operations. Importantly, they also provide important competitive pressures against one another--a fact that is increasingly true in an age of

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187. See *supra* Part II.B.iii.

188. Previts and Merino note:

From the crash until the end of World War II, political reformers were attempting to integrate capitalism and administrative theory. At first it was assumed that regulation could not be reconciled with capitalism because regulation rejected the fundamental belief in the efficacy of competition in the marketplace. But it soon became apparent that administrative theory did not negate the need for a self-regulating mechanism; it simply *shifted the focal point from the individual to groups—from self-regulation through economics to self-regulation through politics*. Political leaders did not look to accountants initially to implement reforms; the profession had to convince politicians, and later regulators, that independent audits could provide protection for investors. Accountants found support from businessmen and the leaders of the stock exchanges, who preferred private sector audits to direct government oversight.

PREVITS & MERINO, *supra* note 22, at 270 (citations omitted) (emphasis added).

189. See *infra* note 202 and accompanying text (discussing politicization following World War II).

190. MACEY, *supra* note 32, at 156.



multinational corporate operations and great technological capability to communicate globally.

Accounting cannot truly be said to be self-regulated for a variety of reasons. First, there is no clear definition of a professional accountant,<sup>191</sup> thus no organization can possibly police those within the boundary of the profession. More importantly, even CPAs who audit public companies have professional obligations to a variety of organizations.<sup>192</sup> Even setting aside the government regulators (the SEC and state accountancy boards), some accounting oversight bodies importantly lack the “self” part of self-regulation. That is, because their leadership is not necessarily part of the public accounting profession, as in the case of the PCAOB, they cannot be considered *self*-regulating institutions.

### iii. Government Regulation

Government regulation is the most coercive form of regulation, but also the most powerful. Government regulation is frequently criticized for actual and perceived waste, yet it also brings with it the most enforcement power to effect regulatory change. The strongest benefits of government regulation may be its uniformity and enforceability, but these attributes also entail trade-offs in flexibility.<sup>193</sup>

Accounting is not genuinely government regulated, as evidenced by the fact that the FASB, a private organization, is the primary standard-setter.<sup>194</sup> The SEC, a government agency, does have statutory authority to regulate accounting, at least in the context of publicly traded companies, but has largely delegated this authority back to the FASB.<sup>195</sup> Except for the IRS in the case of income taxation, the federal government generally has very little to say about accounting (including public accounting services performed by CPAs) in privately held businesses. Even with public companies, the PCAOB now has jurisdiction virtually identical to the SEC, yet is explicitly a private, non-governmental entity.<sup>196</sup>

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191. *See supra* Part II.B.i.

192. *See supra* Part II.B.iii.

193. “Corporate law’s fiduciary duty principles may be superior to rule-like approaches to managerial decision-making because promulgators cannot envision all future circumstances in which discretion is necessary to enable operational flexibility.” Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of “Principles-Based Systems” in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411, 1424 (2007).

194. *See supra* Part II.B.iii.

195. *Id.*

196. Although the PCAOB’s jurisdiction—the entities over which it has authority—is much like the SEC’s, PCAOB’s mission and operation is vastly narrower, as it is not a clearinghouse for all public company information, as the SEC is. *See supra* Part II.B.iii. Moreover, the SEC has been rather successful in asserting its authority or at least *de facto*

#### iv. Hybrid Models

In reality, to a large extent, none of the three regulatory paradigms just discussed (market, self, or government) actually dominate any industry. Although some areas may exhibit more or less of a particular influence, virtually all fields are regulated by a variety of public and private institutions, formal and informal alike. Some of this may be the product of competing evolutionary paths under different administrations, but much of it is deliberate.

Negotiated rulemaking is one type of hybrid model, in that it incorporates the voice of institutions which might have emerged as market- or self-regulating organizations into the formal process of government rulemaking. This is done in a substantial and meaningful way in the negotiated rulemaking process, and goes far beyond the mere notice and comment provisions required of all federal regulation. Even hybrid models, however, remain essentially market, self, or governmental in their regulatory outlook. In the case of negotiated rulemaking, for all the increased voice and flexibility, it is essentially governmental in its perspective.

Securities, for instance, are regulated by both federal regulators (the SEC) and SROs (like the NYSE). Yet while SROs are given broad leeway in their individual operations, the SEC is clearly the dominant regulator of the industry. In other cases, private and public producers exist simultaneously, and the private producer must meet the performance standards set by the public competitor.<sup>197</sup> Although this type of “yardstick competition” is mostly a relic of the early twentieth century, the Tennessee Valley Authority still serves in this role.<sup>198</sup>

#### *D. What is Accounting’s Regulatory Model?*

If only because of the sheer number and constitution (private, governmental, and quasi-governmental) of organizations involved in the regulation of accounting, the profession follows none of the traditional regulatory paradigms. Multiple organizations, both public and private, share in the oversight and regulation of financial accounting standards and practice. Itself originally an institution of market regulation, public accounting’s audit function has become increasingly quasi-governmental in its structure, with private institutions being given authority by government agencies and even by Congress. In the case of the PCAOB, a private non-profit has been created by congressional charter and is funded by fees

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control over the PCAOB. *Id.*

197. HARRISON, MORGAN, AND VERKUIL, *supra* note 179, at 495-96.

198. *Id.*

assessed and collected by the federal government on other private organizations, *i.e.*, publicly traded corporations).<sup>199</sup> Yet this *private* organization has also been granted *enforcement authority* by Congress, raising substantial questions about process and other issues of constitutionality.<sup>200</sup>

State boards of accountancy appear to serve little independent purpose. They collect licensing revenues for the state, but rely on the national organizations (the AICPA and NASBA) for the bulk of their regulations. NASBA exhibits a mix of public and private interests, and the AICPA is non-obligatory for CPAs and thus suffers from a lack of actual authority over all CPAs. The FASB, as a private association, has only *de facto* authority, except as pertains to SEC-registrants, because the SEC has delegated its standard setting authority to the FASB. These organizations neither wholly complement nor wholly compete with each other, but distribute amongst themselves complex and overlapping responsibilities.

I agree with the many critics who believe that accounting is in desperate need of a fix, but recent “reforms” like the creation of the PCAOB have only been further duplicative of accounting’s already redundant and ineffective oversight mechanisms. Instead of competitive jurisdictional and substantive overlap, which might result in better governance, accounting’s oversight bodies have very effectively delegated their functions amongst each other, creating lucrative niches for oversight professionals. If accountants are gatekeepers, their own gate is in desperate need of mending.

Structurally, accounting may be a mess, but how good is professional accounting at its ultimate purpose--fairly presenting financial conditions? That is the question taken up in Part III.

### III. SUBSTANCE

If, as argued in Part II, accounting’s form and organizational structure is chaotic and ineffective, how does accounting stand up in an evaluation of its substantive rules? Better; not perfect, but better. Not perfect, however, is not necessarily wrong. The underlying transactions of accounting are sometimes impossible to represent objectively; choosing among equally imperfect methods and demanding detailed disclosures is likely the best we can expect. Accounting, like a photograph, is simultaneously a literal and selective (or subjective) depiction of an event or condition. Both accounting and photography memorialize that which has actually happened, often in great detail. Both may also distort or obscure that image

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199. *See supra* Part II.B.viii.

200. *Id.*

or event, intentionally or not.

Accounting is flexible, as it should be, and reformers should be careful to make sure that any accounting reforms recognize and retain accounting's inherent flexibility and need for discretion. Section A of this Part discusses various aspects of the imprecision and imperfection of accounting data and practice. Section B shifts to a more philosophic grounding of these issues. Accounting, and particularly early twentieth century accounting theory in the U.S., had an animating recognition of its epistemological foundations, assumptions, and obstacles. U.S. accounting theory was greatly influenced by concurrent movements in philosophical pragmatism, and particularly that of John Dewey.

Accounting has also often been compared to and discussed as an art. A common trope in this vein is to discuss financial statements as a photograph. Discussing artistic and pictorial dimensions of accounting, however, also taps into accounting's epistemological background and foundations, and promotes further discussion of accounting's limits and challenges that are overarching, not specific, questions to the discipline. Many criticize those engaged in "earnings management" for smoothing out irregularities to make earnings appear healthier, yet surely we encourage photographers to do just that when making our portraits. Is "truth" different in these examples as a matter of kind or degree?

Section C returns to questions about contemporary accounting practice, particularly the heated discussion of fair value accounting, including FAS 157 and mark-to-market accounting. Both fair value and its alternatives can be problematic under different circumstances, and no depiction of financial data is, or ever can be, perfect. To direct policies and laws under the mistaken notion that financial statement presentation can be perfect is reckless and only sets the public up for feelings of mistrust and betrayal against accounting and accountants when inevitable problems arise.

To admit that accountants are engaged in a fundamentally indeterminate task is not, however, to make them unaccountable, or even to suggest that they should not always strive toward a better representation. Accounting may be improved, but it will never be a panacea to the woes of financial reporting, corporate governance, or the economy.

#### A. *The Myth of Objective Valuation*

GAAP is not the lucid or encyclopedic set of pre-existing rules that the dissent might perceive it to be. Far from a single source accounting rulebook, GAAP "encompasses the conventions, rules, and procedures that define accepted accounting practice at a particular point in time." GAAP changes and, even at any one point, is often indeterminate. "[T]he determination that a

particular accounting principle is generally accepted may be difficult because no single source exists for all principles." There are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question. When such conflicts arise, the accountant is directed to consult an elaborate hierarchy of GAAP sources to determine which treatment to follow.<sup>201</sup>

Even the Supreme Court of the United States has weighed in on the objectivity and determinacy of accounting. GAAP provides guidance, but it is also constantly changing and difficult to navigate. Accounting in any form--rules or principles--is not neutral. Accounting rules set the agenda for management by creating or changing incentives in the presentation of financial statements and disclosures. And accounting is political.<sup>202</sup>

Accounting rule changes do not merely influence financial statement presentation, but may also change incentives and behavior in ways both foreseen and unforeseen. This is equally true of fair value and historical cost accounting. "Historical-cost-based financial statements . . . allowed financial institutions to engage in 'gains trading'" to manage earnings by either selling or holding securities whose book and market values varied drastically, in order to manipulate reported earnings.<sup>203</sup> Importantly, fair

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201. *Shalala v. Guernsey*, 514 U.S. 87, 101 (1995) (citations omitted) (emphasis added).

202. *See, e.g., supra* note 188 and accompanying text. By 1952, some leaders in the profession believed that "if accounting income had not already become a political phenomenon, it was well on its way to becoming one." PREVITS & MERINO, *supra* note 22, at 302. Much of the theoretical foundation for accounting as developed in the early twentieth century was a direct result of political pressure and the emerging profession's desire to justify its control over financial reporting:

Corporate abuses had given accountants a clear mandate from the political sector. Demands for corporate publicity to protect both investors and creditors accelerated throughout the period, and it became clear at the Industrial Commission hearings that secrecy would no longer be tolerated. While proprietary theorists welcomed the call for publicity, they also recognized the potential threat if the stockholder/owner were not kept at center stage.

*Id.* at 210 (footnotes omitted). Moreover, the development of specialized governmental accounting was a pressing need well before the Civil War to combat corruption and the spoils system in politics around the nation, although reform would come only a generation later. *Id.* at 97.

203. 2008 SEC Report, *supra* note 11, at 36 (footnote omitted). The report continues:

With the greater interest rate volatility in the 1980s, financial institutions were increasingly in the position of holding assets or liabilities where the current market values of these financial instruments differed markedly from their historical cost values shown in their financial statements. In this situation management could opportunistically choose which assets to sell, or which liabilities to settle, in order to realize gains (or losses) in particular accounting periods. This afforded management a powerful income statement management tool. In addition, for financial institutions short of capital, this created an incentive for the management to sell their well-performing assets in order to

value accounting often works to keep assets on the balance sheet valued realistically, particularly in light of asset devaluation.<sup>204</sup> Historical cost accounting created a different set of incentives--incentives which also gave rise to some of the misrepresentations at Enron.

“Judgment is certainly not new to accounting or auditing” and fair value is no exception to that.<sup>205</sup> But neither is fair value the lone cause of what some would characterize as an increase in accounting subjectivity. Accounting struggles to faithfully reflect business realities, and the increasing complexity of financial instruments has increased the role and need for the exercise of judgment by accountants and auditors to fairly represent an entity’s condition to outsiders.<sup>206</sup> Further, complexity also increases the scope and impact of fair value accounting within an entity.<sup>207</sup>

Fair value and its pro-cyclicality might have created a type of market hysteria,<sup>208</sup> but the traditional alternative of historical cost makes credit harder to obtain for a lot of firms taking entrepreneurial risks, because it is difficult for them to leverage the value of appreciating assets. This in turn creates more incentives to hide details in the financial statements, or attempt to get around reporting values altogether, as at Enron.<sup>209</sup> Financial accounting rules, “in addition to having a goal of presenting a fair and accurate picture of a company’s finances and operations . . . may be used legitimately in such a way as to obscure underlying economic reality,” as in so-called “off balance sheet financing.”<sup>210</sup>

Neither is accounting insulated from political realities and influences. While fair value is being attacked in today’s political discourse, its specific forms may themselves be political creations. One important argument in favor of fair value accounting is its ability to combat the effects of inflation.<sup>211</sup> To fight the distortions of inflation, one might reasonably value accounts in either current *cost* or current *purchasing power* (both are types of ‘fair value’ accounting), among other choices.<sup>212</sup> In the U.K., however, the government made “not an accounting choice but a political one,”

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realize gains to boost their capital, but retain their poorly-performing assets (which had unrealized losses).

*Id.*

204. Donius, *supra* note 50.

205. 2008 SEC Report, *supra* note 11, at 189.

206. *Id.*

207. *Id.* at 104.

208. *See supra* Part II.A.

209. Arewa, *supra* note 14, at 23 (discussing “synthetic” leases and the notorious “special purpose entities” used by companies, including Enron, to appear less leveraged).

210. *Id.* at 28.

211. *See* MYDDELTON, *supra* note 7, at 131; PREVITS & MERINO, *supra* note 22, at 304-06.

212. MYDDELTON, *supra* note 7, at 132-36.

insisting upon current cost methodology instead of current purchasing power.<sup>213</sup> Because accounting is subjective and subject to shifting incentives as a result of external actions, politicians often end up complaining about problems, such as overstated earnings, that are themselves a product of political decisions, as with the choice of current purchasing power in the U.K.<sup>214</sup>

Much of the criticism of fair value accounting (and, equally, of historical cost accounting) somewhat misses the point: all accounting rules have inherent problems and bring with them incentives which may create additional problems. Any systematic method of representing financial data is going to have these types of problems with over-breadth and imperfection. “[T]he balance sheet necessarily omits many items that are of financial value to the business but cannot be recorded objectively,” with respect to both assets and liabilities.<sup>215</sup> “Principles-based accounting” advocates, who want financial statements to “present fairly” using an appropriate method, but *not* have fixed rules, do not often take into account that relying on judgment is at least as flawed as fixed rules. Even if there are ways, *e.g.*, liability rules, to keep poor judgment about “principles” in check, the enforcement costs of standards or principles may be high. On the other hand, penalizing those who follow what many would call the letter, but not the spirit, of accounting rules may also be very costly. “Promulgation and compliance costs vary. In general, rules are more costly than principles to create, while principles can impose higher compliance costs. When rules enable relatively cheap compliance, compliance is more likely. In contrast, when compliance with principles is relatively costly, the risk of non-compliance rises.”<sup>216</sup>

Lawrence Cunningham has leveled a needed and convincing criticism against this binary debate over the supposed principles-versus-rules nature of accounting systems. Cunningham concludes that *any* system of accounting is somewhere along a continuum which *necessarily includes both rules and principles*.<sup>217</sup> Our search for the perfect system of accounting may be utopian folly at best, but it is further obscured by the binary terms of the debate.<sup>218</sup> Cunningham is correct when he concludes:

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213. *Id.* at 135.

214. *Id.* at 138.

215. KIESO ET AL., *supra* note 9, at 190.

216. Cunningham, *supra* note 193, at 1424 (footnotes omitted).

217. “All these systems contain a blend of provisions ranging from the particular to the general, from those providing precise *ex ante* instruction to those defined after the fact.” *Id.* at 1413.

218. “These classifications are too crude to describe or guide the design of corporate law, securities regulation, or accounting systems. Inquiry concerning the nature of rules and principles demonstrates how these labels invariably require sorting individual legal or accounting provisions onto a continuum rather than precisely fitting them into two neat

*“If it is infeasible to establish a principles-based system of corporate law, securities regulation, or accounting, then it is misleading to promote the possibility.”*<sup>219</sup> Moreover, Cunningham also rightly emphasizes the evolving nature of accounting, and the fact that managers will always seek to bend, stretch, or work outside the framework, calling this “creative compliance” unavoidable.<sup>220</sup> Perfection is impossible if only because accounting will always be a moving target. Sometimes it is obvious that one method of accounting is best, but most of the time it is *not*.

i. Stock Options, for Example

A startup firm is unlikely to be successful and ever have any significant costs related to the options they grant. However, if the company actually survives and prospers, and people exercise the options to cash out, we then know conclusively that the options were in fact costly, and by just what amount. Of course, this knowledge is realized only years after the options are granted and their contingent liabilities incurred. Thus we often cannot know what actually is fair until the future; yet, we also demand financial reporting of today’s circumstances while that information is still relevant to making decisions in the near future. U.S. GAAP now requires the current expensing of options and valuation on the financial statements according to options pricing models.<sup>221</sup> The debate over the topic is often said to have lasted from 1972 through 2004,<sup>222</sup> but the problem had actually been identified and discussed for decades prior to 1972, with the first accounting standard on the subject issued in 1948.<sup>223</sup> In fact, the “long history of the theory of option pricing began in 1900 when the French mathematician Louis Bachelier deduced a simple option pricing formula.”<sup>224</sup> The 1972 date refers to the formal revisiting of the issue, just months before the publication of the Black-Scholes option pricing model,<sup>225</sup>

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categories.” *Id.*

219. *Id.* at 1492 (emphasis added).

220. *Id.* at 1478. “True, in corporate law, equitable principles can police mere technical compliance, and in securities regulation, the broad-gauged anti-abuse principles contribute. But, in general, *regulatory pursuit of creative compliance is Quixotic*—except perhaps through rhetoric.” *Id.* at 1478-79 (emphasis added) (footnotes omitted).

221. *Share-Based Payment*, Fin. Acct Series: Statement of Fin. Acct. Standards No. 123 (Fin. Acct. Foundation) Dec. 2004, at ¶ 22, available at <http://www.fasb.org/pdf/fas123r.pdf>.

222. Nicholas G. Apostolou & D. Larry Crumbley, *Accounting for Stock Options: Update on the Continuing Conflict*, CPA JOURNAL, Aug. 2005, available at <http://www.nyssepa.org/cpajournal/2005/805/essentials/p30.htm>.

223. KING, *supra* note 74, at 162.

224. Robert C. Merton, *Theory of Rational Option Pricing*, 4 BELL J. ECON. & MGMT. SCI. 141, 141 (1973).

225. See Fisher Black & Myron S. Scholes, *The Pricing of Options and Corporate*



which would forever change the valuation of options.<sup>226</sup> Yet there remain many critics, even today, as to the appropriateness of options price modeling in financial *accounting*:<sup>227</sup>

Smaller high-tech companies were very vocal [in opposing expensing], arguing that offering stock options was the only way they could hire top professional management. Furthermore, they claimed that the losses that would result from forcing them to recognize stock options as compensation expense would impair their stock price and put them at a disadvantage compared to larger corporations better able to absorb the expense of stock options.<sup>228</sup>

For firms that are not successful and never have conditions sufficient to make exercising options attractive, the modeled expense has added greatly to the cost of issuing options.

None of this discussion is to say that expensing options is unmitigated evil, but merely to note that the rule to expense stock options when granted does more than simply compel truthful presentation, and it may not even do that. While I do not question the relative accuracy of options pricing models, I do question their place in *issuers'* financial statements. They are a valuable tool for economics and finance, but their place in accounting is less clear. For someone trading in options, sophisticated pricing models showing discounted values of a diverse portfolio of options are ideal. Options pricing models are excellent at representing expected future value of a stock option, but expected values are statistical depictions of

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*Liabilities*, 81 J. POL. ECON. 637, 637 (1973) (arguing that the "equilibrium condition can be used to derive a theoretical valuation formula."). See also Merton, *supra* note 224, 141 (discussing the model and its implications and coining the term "Black-Scholes theory").

226. KING, *supra* note 74, at 163.

227. *Statement of Fin. Acct. Standards No. 123*, *supra* note 221, at ¶ B59. The Statement further stated that:

Critics generally asserted that available valuation techniques, especially the Black-Scholes-Merton option-pricing formula and similar closed-form models, do not adequately take account of unique features of employee share options. They also pointed out that closed-form models may not be the best way to estimate the fair values of long-term options, even those without the unique features of employee share options, because those models are limited to single weighted-average assumptions for expected volatility and expected dividends. Some recommended deferring required recognition of compensation cost from employee share options until a better valuation technique for those instruments is developed. They contended that recognizing compensation cost based on fair value estimated using currently available valuation techniques would add an unacceptable level of measurement error to financial statements and impair their reliability and comparability.

*Id.*

228. Apostolou & Crumbley, *supra* note 222.

expectations about the future, not reports of the past or current *condition*. The issuer of options, however, is not looking at a diverse portfolio, but a potentially large, if also remote and unpredictable, *contingent* expense arising from the option grant, likely in the fairly distant future.

If options are exercised, their discounted cost in prior years' financial statements may be understated. For unexercised options, though, an artificial expense was created. In either case, the particular period or periods in which the expense should be debited is of further concern, because the "matching principle" of accounting says that expenses should appear in the financial statements in the period they were incurred.<sup>229</sup> Arguments based on matching can easily be formulated either in support of, or opposed to, the immediate expensing of stock options, even setting aside the problems of valuation.<sup>230</sup> But, really, when was the expense incurred for an option held for ten years while a company transformed from start-up to behemoth?

A simple illustration might best make the point. Imagine that Startup Company gives me, an employee, a promise of a \$100 bonus if the company is profitable for each of the next five years, but nothing otherwise. The odds of this happening, let's say, are 50/50. Startup Company will either owe me \$100 or \$0 in five years. One way to model this cost today is to expense the discounted present value of \$50, the probabilistic cost of the bonus promise in five years. The problem is obvious: under no circumstance will that be the actual cost to Startup Company of the bonus promise, which will owe me *either \$0 or \$100, but not \$50*. If these bonus promises are tradable (like some stock options), then someone might develop a portfolio of bonus promises from many firms, in which case the probabilistic cost is a critical number: buy at any price under the present value of \$50 in five years. For Startup Company to expense *either* \$0, \$50, or \$100 (or any other amount) when the promises are made is an imperfect representation of this contingent liability, but to

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229. "[T]he matching principle . . . dictates that efforts (expenses) be matched with accomplishment (revenues) whenever it is reasonable and practicable to do so." KIESO ET AL., *supra* note 9, at 46. "In recognizing expenses, the approach to be followed is 'let the expense follow the revenues.'" *Id.* Generally, matching means that expenses are booked when the revenues associated with them are recognized. *See also* MYDDELTON, *supra* note 7, at 115-16 (noting that revenue recognition practices have evolved in the U.K. over years, following the matching principle, even in the absence of formal accounting standards on specific recognition practices).

230. "Expenses are recognized not when wages are paid, or when the work is performed, or when a product is produced, but when the work (service) or the product actually makes its contribution to revenue." KIESO ET AL., *supra* note 9, at 46. Allocation policies, *e.g.*, depreciation are formulated and used "[f]or those costs for which it is difficult to adopt some type of rational association with revenue," but items "may be expensed immediately" when periodic allocation "does not seem desirable," including period costs such as executive compensation and administrative expenses. *Id.*

say that \$50 is the mandatory treatment implies an element of precision that simply does not exist.

Any of these presentation alternatives merely constitutes a choice among imperfections, not the one and only path to ensure statement of an objective truth. The truth is that, often, virtually nothing about the eventual cost of stock options is known when they are granted. That does not give license to ignore options in financial statements, but it should at least give pause. And, under any valuation, all known and relevant information (including modeled prices) should be *disclosed*.

## ii. Perspective and the Entity Theory of Accounting

Accounting offers a distinct and highly individualized perspective of the data it presents, a perspective quite different from, and more subjective than, that of economics or finance. One person's debit is another person's credit--literally. It is striking that so many Americans today use "debit" cards, since each transaction actually represents a *credit* to the holder's cash account, although it is a *debit* to the bank's account. Credit cards, on the other hand, do represent a credit to the user (an increase in liabilities), as well as a debit (increase in receivables) to the issuer. These are but trivial examples, albeit instructive ones, of the inherently individualistic perspective of the language and practice of accounting.

I noted in the discussion of stock options that, while pricing models are an imperfect (even if necessary) representation for financial statements, they are accurate and extremely useful for certain groups or individuals, notably actual and potential investors. Investors have a different *perspective* than those running a corporation. To expect that accounting data has--or should, or even *could* have--the same perspective as finance or economics is misguided. One school of accounting thought, "entity theory," is the most explicit in recognizing this.

"Berle and Means (1932) . . . argued that separation of ownership and control had rendered traditional accounting profit measurement useless as a means of allocating economic resources."<sup>231</sup> Entity theory sought to depose the Berle and Means "challenge" by asserting "that managers sought to maximize returns *to the firm*, not to any particular user group, such as stockholders."<sup>232</sup> One of its advocates and formulators, A. C. Littleton, asserted that entity theory's origins dated to the sixteenth century, but only in the twentieth century, after its full exposition, did it start to significantly affect accounting debates.<sup>233</sup> Today, the impact of entity theory is minimal at best, and has been largely forgotten. Yet, it still points to sources of

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231. PREVITS & MERINO, *supra* note 22, at 281.

232. *Id.* (emphasis added).

233. *Id.* at 222.

significant disagreement about the nature and evolution of accounting.

“The first comprehensive statement of entity theory”<sup>234</sup> appeared in 1922, ten years before the publication of Berle and Means’s *The Modern Corporation and Private Property*, in William Paton’s *Accounting Theory*.<sup>235</sup> Later, in 1940, Paton would team up with Littleton to specifically respond to Berle and Means in Paton and Littleton’s *An Introduction to Corporate Accounting Standards*, published by the American Accounting Association (“AAA”).<sup>236</sup> This later book further developed the entity theory of accounting, but did not differ significantly from Paton’s own 1922 version. Of note, the 1940 jointly-authored “monograph was the only AAA publication ever to be read widely by practitioners.”<sup>237</sup> Their work, however, along with that of other “early giants of accounting research,” was eschewed by the 1960s, in a move within the academy to more “scientific” accounting research.<sup>238</sup> “Their work had focused on issues such as whether goodwill is an asset, *whether to measure balances at cost or value*, or whether an accounting unit should be considered a proprietorship or an entity”<sup>239</sup>--issues of tremendous importance even today. This research was replaced with the “[u]se of integral calculus, algebraic transformation, and words like *submartingale model* [which] scared away common readers.”<sup>240</sup> However useful and important the latter tools might be, we are left, decades later, facing the direst of consequences from not having settled the questions with which Paton et al. were concerned.

Paton was conscious of the importance of perspective, and sought to reform accounting with that in mind:

It is hoped that this discussion may help to unravel the confusion of accounting and economic ideas and terminology in which many accountants (and perhaps some economists) appear to have lost themselves. The *accountant naturally looks upon the business world through the eyes of the individual enterprise; the economist views the situation primarily from the standpoint of an entire industrial community, a whole market situation*. Consequently concepts and terms extremely valid in one field cannot be transferred to the other without, at any rate, very careful qualification. Yet . . . *the accountant has often made unwarranted use of certain concepts of the economist*. Similarly

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234. *Id.* at 260.

235. WILLIAM ANDREW PATON, ACCOUNTING THEORY: WITH SPECIAL REFERENCE TO THE CORPORATE ENTERPRISE iv (Scholars Book Co. 1973) (1962).

236. PREVITS & MERINO, *supra* note 22, at 281.

237. KING, *supra* note 74, at 92.

238. *Id.* at 92-93.

239. *Id.* at 93 (emphasis added).

240. *Id.*

some economists have attempted to make dubious applications of the *point of view of the business enterprise* to the problems of economic theory.<sup>241</sup>

Valuation of most any asset or liability is complicated and, perhaps, rather different based on your point of view. If I have a large and diverse portfolio of investments, then discounting each one by its risk makes perfect sense, as already discussed regarding stock options. And it also makes perfect economic sense that an insurance company is willing to sell me a life insurance policy that will pay someone \$X upon my death. But it seems terribly odd to think (either myself or for my beneficiary to do so) that my life today is simply worth \$X, even if I am 'fully' insured for \$X. Even setting aside loss of life, it seems pretty strange to say that I am indifferent to sustaining home or auto damage simply because I am insured against such harm, for there are other costs (both intangible and indirect financial ones) incurred when any such tragedy befalls. Even if the economic costs are identical, the actual (total, tangible and intangible) costs of a tragedy are much higher than the insured value. This difference is difficult to quantify, but it is important to remember that it exists.

In accounting, it seems similarly strange to expect that a company can and will make "objective" valuations about their own condition instead of making representations in light of subjective factors, including their hopes and expectations. This is information which the company has a bias in representing, but also information that they are in the best position to know, or at least to give evidence of. Even when individuals are honest it may not be true that their memories clearly or accurately depict their intentions.<sup>242</sup> And "independent" audits do not necessarily foster an environment where auditors are necessarily privy to this information, nor are they in such a position as to demand such knowledge from their clients.<sup>243</sup>

For me to value my own life as priceless while an insurance company assigns a tradable value to that same life can still seem like logically consistent positions; we can see the matter from different perspectives. But talking about an abstract hypothetical is far different from expecting people (and companies) to look objectively at their own circumstances from different perspectives. So why should we expect, and build rules around the assumption, that companies are going to (or even should) value their

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241. PATON, *supra* note 235, at xv-xvi (emphasis added) (footnote omitted).

242. See Daniel Austin Green, *Intention and Interpretation*, (draft Jan. 11, 2010) available at <http://ssrn.com/abstract=1404203> (discussing the debates about whether mental states, including memories, are relevant to determining intentions). See generally G.E.M. ANSCOMBE, *INTENTION* (1957) (rejecting the relevance of mental states to intentions).

243. See Daniel Austin Green, *Whither and Whether Auditor Independence*, 44 GONZAGA L. REV. 365, 379 (2009) (discussing clients' incentives to hide information from auditors).

own interests exactly as an outsider would?

Unrealistic managerial optimism (even if honest) is an obvious problem, yet pessimism is not something most principals want inculcated in, or by, their agents. *Ceteris paribus*, stockholders want savvy but bullish, not bearish, managers. One cannot blindly trust firms (or auditors) to make these kinds of judgments; yet, one cannot rely solely on formulaic rules either.<sup>244</sup> Although we are right to care about accuracy, accounting is not scientific; accounting is at least as much about judgment (“art”) as it is about scientific measurement.<sup>245</sup> This is true of all asset valuation, but even more so as we move away from the tangible.

### iii. The Intangibles Haze

In a 2006 law review article, Olufunmilyo Arewa called accounting in the age of today’s “intangibles paradigm” the “intangibles haze.”<sup>246</sup> The term, she said, “refers to the fact that current accounting treatment of intangibles often results in financial statements that are unclear and not reflective of underlying economic reality.”<sup>247</sup> There remains no consensus and, today, both market and historical values are regularly used in financial statements’ representation of the value of intangible assets.<sup>248</sup> Nor is this a twenty-first century issue: “Debates over the accounting treatment of intangibles are certainly not new and date back more than a century.”<sup>249</sup> Lack of consensus, however, may be a virtue, leading to an interrelated set of financial statements that do not put too much emphasis on *either* historical cost *or* fair value accounting.

Arewa focuses in part on the fact that internally generated intangibles are considered current period costs and appear as operating expenses on the income statement, while purchased intangibles are capitalized and appear as assets on the balance sheet.<sup>250</sup> The significance of this treatment is that “[i]t tends to result in distortions of reported financial statements because such financial statements do not accurately reflect the true economic value of many business enterprises.”<sup>251</sup> Accounting for intangibles in the same manner as tangibles, where many costs are capitalized as assets, would

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244. “The precise trade-off between certainty and context is not always clear.” Cunningham, *supra* note 216, at 1424.

245. See Green, *supra* note 243, at 376-79 (detailing the importance of judgment to performing independent audits).

246. Arewa, *supra* note 14, at 66.

247. *Id.*

248. *Id.* at 67.

249. *Id.*

250. *Id.* at 68-69. See also *Business Combinations*, Fin. Acct. Series: Statement of Acct. Standards No. 141, (Fin. Acct. Foundation) Dec. 2007, at ¶¶ 47-51.

251. Arewa, *supra* note 14, at 70.

affect companies in different ways. Particularly, in the case of firms with increasing amounts of research and development (like startups), their income would rise and they might appear (more) profitable.<sup>252</sup> On the other hand, firms with large and relatively stable research and development expenses (like large pharmaceutical companies) would appear to have a lower return on capital (“ROC”),<sup>253</sup> an important number to many investors.

Accounting’s current method of accounting for intangibles, then, results in a clear reporting advantage for large incumbents benefiting from high ROC ratios.<sup>254</sup> (And one wonders whether most investors realize that this ROC calculation at such firms does *not* include R&D costs as capital investments.) Moreover, not only do upstarts not receive this advantage, but their research and development costs are not capitalized at all, *i.e.*, they have no research and development assets on their balance sheets, because they have not acquired other firms. This contrasts with capitalized research and development assets for their large, established competitors that have purchased other firms whole. These startup firms likely have low or negative net income in any event, but their overall financial condition appears substantially worse than it might be fairly stated were research and development capitalized as assets.

As in the case of stock options, perfect presentation of intangibles might be impossible. Neither full current expensing nor complete capitalization perfectly represents economic reality. But “[t]he rise of intangibles has highlighted potential deficiencies in existing accounting rules as is evident in the fact that U.S. GAAP has essentially not fully confronted the reality of this new paradigm.”<sup>255</sup> This is especially relevant because of the intangibles backdrop with which so many recent corporate scandals have taken place.<sup>256</sup> The increasing role of intangibles in the economy,<sup>257</sup> coupled with lagging accounting treatments, “has enabled

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252. Arewa, *supra* note 14, at 71.

253. *Id.*

254. This is standard, “generally accepted,” or canonical accounting practice. Recall, though, that “off-balance sheet” financing through SPEs is used for the same purpose of improving ratios important to investors. Arewa, *supra* note 14, at 23. Intangibles and SPEs might be on different sides of the line between fair presentation and manipulation, but that line is often blurry.

255. *Id.* at 72 (citing Steven M.H. Wallman, Remarks at the International Intellectual Property Institute Presentation: Intangible Assets, Valuation and Accounting Standards 5 (May 1, 2002), available at [http://www.iipi.org/conferences/Accounting\\_Standards/transcript.pdf](http://www.iipi.org/conferences/Accounting_Standards/transcript.pdf)).

256. *Id.*

257. Even setting aside conventional intangibles—things that might be capitalized as asset—it has been estimated that a full twenty-five percent of U.S. gross domestic product arises from “the persuasive and judgmental part of transactions costs, that is, to *sweet talk*,” and that this amount will only increase because “[t]he machine-like part can get better and better, yet leave the human part still requiring persuasion.” Donald McCloskey & Arjo

certain companies to obfuscate their financial reporting, and has increased their capacity to engage in fraud.”<sup>258</sup>

Goodwill is a particularly, and increasingly, important intangible. We speak of goodwill, colloquially, in a variety of ways. Trade amongst individuals is often greased by, or even arises from, “goodwill” between them.<sup>259</sup> A special customer might be the beneficiary of “goodwill.” And the large and popular non-profit Goodwill Industries helps train people with special needs for future employment.<sup>260</sup> In the context of branding, we often hear that companies like Coca-Cola, Nike, Procter & Gamble, and countless others, have a substantial reserve of “goodwill” among consumers.<sup>261</sup> This use of the word is closest to, yet still distinct from, the modern accounting definition of goodwill.

To the contemporary accountant, goodwill is: “The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed.”<sup>262</sup> The value of Coca-Cola is not simply its shareholders’ equity, *i.e.*, assets minus liabilities. Goodwill, then, seeks to represent the difference between the true economic value of a company

Klamer, *One Quarter of GDP Is Persuasion*, 85 AM. ECON. REV. 191, 192-93 (1995).

258. Arewa, *supra* note 14, at 80 (footnote omitted).

259. As Adam Smith wrote:

When an animal wants to obtain something either of a man or of another animal, it has no other means of persuasion but to gain the kindness and favour of those whose service it stands in need of. *A puppy fawns upon its dam, and a spaniel endeavours, by a thousand attractions, to engage the attention of its master who is at dinner, when it wants to be fed by him. Man sometimes uses the same arts with his bretheren, and when he has no other means of engaging them to act according to his inclinations endeavours by every fawning attention to obtain their goodwill.* He has not time, however, to do this upon every occasion. So necessitous is his natural situation that he stands at all times in need of the cooperation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons.

ADAM SMITH, LECTURES ON JURISPRUDENCE 571 (R.L. Meek, D.D. Raphael & P.G. Stein eds., Liberty Fund 1982) (1762) (emphasis added).

260. “We are North America’s leading nonprofit provider of education, training, and career services for people with disadvantages, such as welfare dependency, homelessness, and lack of education or work experience, as well as those with physical, mental and emotional disabilities.” Goodwill Industries, <http://goodwill.org/page/guest/about/whatwedo>.

261. See PATON, *supra* note 235, at 313 (“Managerial ability, methods and processes, territorial location, trade-name—these and numerous other factors may contribute to financial success. . . . With respect to these collateral factors and conditions some enterprises are more favorably situated than their representative competitors. Such businesses may be said to have *goodwill*.”).

262. FIN. ACCT. STANDARDS BD., *Goodwill and Other Intangible Assets*, in STATEMENT OF FIN. ACCT. STANDARDS NO. 142, 105, available at [www.fasb.org/pdf/fas142.pdf](http://www.fasb.org/pdf/fas142.pdf). An earlier definition was “the estimated value of future excess income.” PATON, *supra* note 235, at 313.



and its equity. Just like accounting for other intangibles, goodwill is not (for accounting purposes) generated internally, but is realized only when other entities are acquired.<sup>263</sup> Moreover, goodwill is no longer amortized, but remains on the books indefinitely--potentially forever, subject to annual tests for impairment.<sup>264</sup> One interesting argument for amortizing goodwill is that “acquired goodwill is an asset that is *consumed and replaced with internally generated goodwill* and that the acquired goodwill therefore must be amortized (even though the internally generated goodwill that is replacing it cannot be recognized as an asset).”<sup>265</sup> The Financial Accounting Standards Board decided not to require amortization after making the following acknowledgement:

“[N]ot all goodwill declines in value and . . . goodwill that does decline in value rarely does so on a straight-line basis. Because the Board agreed with respondents who stated that straight-line amortization of goodwill over an arbitrary period does not reflect economic reality and thus does not provide useful information, the Board reconsidered its decision to require amortization of goodwill.”<sup>266</sup>

The intangibles haze, like stock options and the entity theory of accounting, reminds us of the practical problems of representing financial reality. Stock options, intangibles, threatened or pending litigation, and countless other situations present circumstances full of contingency and uncertainty. These attributes render perfect representation impossible and may suggest financial data should be reported in multiple ways, with robust disclosure requirements, instead of through monolithic universal mandates of accounting treatments. These practical problems, however, have theoretical roots, and section B takes up discussion of them.

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263. *See id.* at 19-42 (discussing how goodwill is generated).

264. *See id.* at 12 (“Goodwill shall not be amortized. Goodwill shall be tested for impairment at a level of reporting referred to as a reporting unit. . . . Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value.”).

265. *Id.* at 48 (emphasis added). Discussion of the changes to the 1999 Exposure Draft continues: “Another argument was that the useful life of goodwill cannot be predicted with a satisfactory level of reliability, nor can the pattern in which goodwill diminishes be known. Hence, in the 1999 Exposure Draft the Board concluded that amortization over an arbitrary period of time was the only practical solution to an intractable problem and was preferable to the alternative of writing off goodwill immediately because that would be even less representationally faithful.” *Id.* This discussion of goodwill, then, further illustrates the imperfection and imprecision of accounting.

266. *Id.* at 49.

*B. Accounting and Epistemology: Impossibility, Indeterminacy, Pragmatism, and Artistry*

Accounting students generally learn that financial statements are a picture of the company's financial condition. Some statements are time-lapsed pictures and show the changes within a period, like the income statement. The balance sheet, however, is a "snapshot," for it merely shows assets, liabilities, and equity as of the last day of the period. The picture metaphor for accounting, I suggest, is more telling than it seems, though its consequences are seldom discussed.

The ultimate problem of financial accounting and valuation, increasingly important given the complexity of modern transactions, is one of knowledge itself. How do you represent "facts" or "truth" about financial conditions when every conceivable way to observe and present those facts is inherently flawed? If accounting does have its own, internal perspective (as the entity theory asserts),<sup>267</sup> a perspective different from economics' or finance's systemic perspective, then accounting need also have its own theoretical framework. Is accounting an art or a (social) science? Many would argue it is something of both. Moreover, there is a strong link between pragmatism and art with respect to accounting and its influences, which also supports this claim. "Both pragmatism and economic conditions in the United States appear[] to support the . . . position that accountancy [i]s an art."<sup>268</sup>

Impossibility and indeterminacy, two concepts related to problems of knowledge and uncertainty, have come to greatly influence the social sciences, law, and political philosophy, yet remain largely untouched in the contemporary context of accounting. Impossibility rejects the very idea that there are, or can be, "right" answers, while indeterminacy suggests that the same facts can be used to equally support different opinions or outcomes--that the given facts (including precedent) do not always compel particular outcomes. Is accounting plagued by impossibility, indeterminacy, or underdeterminacy?

After discussing impossibility and indeterminacy in section i, section ii turns to philosophical pragmatism's influence on accounting. Section iii, then, focuses on accounting as an art. More specifically, section iv looks at accounting as the art of photography. Section v builds on the relevance of both the still photography and cinema metaphors to suggest ways in which accounting can become more dynamic in its approach, particularly with respect to accounting for intangibles, and ways in which such approaches would confront accounting's problems of determinacy.

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267. See *supra* notes 235-241 and accompanying text.

268. PREVITS & MERINO, *supra* note 22, at 208.

Remembering and working within accounting's limitations, not forgetting or ignoring them, is the best way to make certain that we best employ accounting in corporate governance. Instead of trying to hide accounting's questions of determinacy, we should confront them by emphasizing the knowledge we do have. Publication and utilization of this knowledge, however, is best promoted by broad disclosure requirements and expectations, not by narrow treatment prescriptions.

i. Impossibility and Indeterminacy

A strong formulation of "impossibility" rejects the very existence of truth or objectivity, of right and wrong. Narrower (or weaker) formulations of impossibility identify circumstances, general or specific, under which the desired result is impossible to obtain. Perhaps the most famous such example is Arrow's Impossibility Theorem, writing about social welfare maximization.<sup>269</sup> U.S. debates over accounting during the early twentieth century seem to have been grappling with a rather strong formulation of impossibility, especially in the wake of the 1929 stock market crash:

During the thirties, the profession developed an argument that could be called the 'accounting impossibility theorem.' Conflicting user interests made it impossible to be 'fair' to all users when preparing general purpose financial statements. There simply was no 'right' answer to accounting questions; the appropriateness of any method was determined by the intended use of the financial report. The committee [of the American Institute of Accountants ('AIA')] concluded that 'for the present' various methods must be tolerated, a position the AIA reiterated to the SEC a year later.<sup>270</sup>

Although any "truth" in accounting is subject to qualifications and conditions, there is general agreement over how to account for "easy" transactions. For a \$10 cash sale on Jan. 1, 20XX, we expect that the year-end financial statements will reflect a \$10 debit to cash and \$10 credit to

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269. KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (1951); Kenneth J. Arrow, *A Difficulty in the Concept of Social Welfare*, 58 J. POLITICAL ECON. 328, 328 (1950). The theorem Arrow developed in these two works identifies general conditions under which social welfare cannot be maximized through democratic voting. *Social Choice*, *supra* note 270; *Concept of Social Welfare*, *supra* note 270, at 328. "[T]here are preference patterns which, if held by the individual members of the society, will give rise to an inconsistent pattern of social choice. . . . [And t]he aim of the present paper is to show that these difficulties are general. For any method of deriving social choice, by aggregating individual preference patterns which satisfies certain natural conditions, it is possible to find individual preference patterns which give rise to a social choice pattern which is not a linear ordering." *Concept of Social Welfare*, *supra* note 270, at 330.

270. PREVITS & MERINO, *supra* note 22, at 277 (footnote omitted).

sales reflected on the income statement, regardless of the fact that \$10 on Jan. 1, 20XX is (because of the time value of money) likely worth more than \$10 on Dec. 31, 20XX, and numerous other implicit or trivial conditions pertaining to the transaction. Thus, an absolute form of impossibility in accounting cannot be readily defended without contesting the truth and accuracy of even this, the simplest of transactions to account for. But, as section III.A discussed above, many accounting transactions today are impossible to perfectly represent. We might retrench a bit on the matter and instructively update and reinterpret accounting's *impossibility* debate with the language of law's *indeterminacy* debate.

Lawrence Solum, writing in a 1987 law review article, clarified the issues at stake in discussion of law's determinacy by offering the following definitions:

The law is *determinate* with respect to a given case if and only if the set of results that can be squared with the legal materials contains one and only one result.

The law is *indeterminate* with respect to a given case if and only if the set of results in the case that can be squared with the legal materials is identical with the set of all imaginable results.

The law is *underdeterminate* with respect to a given case if and only if the set of results in the case that can be squared with the legal materials is a non-identical subset of the set of all imaginable results.<sup>271</sup>

For the reasons discussed in Part III.A, accounting, even under strong "rules-based" systems, cannot be truly determinate, especially with respect to intangibles, and in light of "creative compliance."<sup>272</sup> Yet neither can accounting be said to be *indeterminate*, because certainly "all imaginable results" would not equate to accounting's ultimate, if somewhat intractable, goal of "fair" presentation. Accounting must, therefore, be *underdeterminate*, where the supportable outcomes are "a nonidentical subset of the set of all imaginable results."<sup>273</sup> Important to a comparison of law's indeterminacy debate to accounting, Solum also likens these distinctions to being rule-bound, unbound, and rule-guided.<sup>274</sup> This certainly comports with Lawrence Cunningham's discussion of accounting as necessarily existing on a continuum of rules and principles.<sup>275</sup> *Rules can*

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271. Lawrence B. Solum, *On the Indeterminacy Crisis: Critiquing Critical Dogma*, 54 U. CHI. L. REV. 462, 473 (1987) (emphasis in original) (footnote omitted).

272. Cunningham, *supra* note 216, at 1478. See also *supra* note 220 (providing the quotation and its context).

273. Solum, *supra* note 271, at 473.

274. *Id.*

275. Cunningham, *supra* note 216, at 1478.

*guide, but they cannot be fully determinate.*

If accounting is underdeterminate, then it will always present issues of uncertainty. Statistical representations are one way to present uncertainty and, increasingly, accounting relies on such methods, as in the case of stock options. Traditionally, however, accounting's answer to uncertainty was the experience and judgment--the artistry--of the accountant. The language of both experience and art led accountants to pragmatism.

## ii. Pragmatism's Influence

In the early twentieth century, both business and government began demanding that accounting be more "scientific," advocating a "rule book" and that accounting be "amenable to definite axioms, and capable . . . of producing definite and exact results."<sup>276</sup> In their defense of accounting as a profession requiring judgment,<sup>277</sup> accountants turned to philosophical pragmatism and, in turn, to pragmatism's notion of the artistic.<sup>278</sup> "Truth was perceived as phenomenally relative; ideas must be tested for practicality and attainability; experience enabled each individual to judge the validity of ideas according to specific circumstances."<sup>279</sup> If this was true, then it was among professional accountants and auditors that experience and judgment was to be found.<sup>280</sup> Accountants embraced pragmatism's idea of "adaptive theory"--the notion that theory, when rooted firmly in experience, could offer further insight into practical problems.<sup>281</sup>

Accounting, however, was not the only place of pragmatism's influence, but merely part of the redefinition of "truth in relation to its practical consequence," which offered a justification for much of the time's progressive activism, in which accountants and other professionals would be given the important role of "disinterested expert."<sup>282</sup> Part of the reason accounting was attracted to pragmatism is simply that the leaders of the

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276. PREVITS & MERINO, *supra* note 22, at 207 (citing Alexander Smith, *The Abuse of Audits in Selling Securities*, in AAPA YEAR BOOK 169, 170 (1912)).

277. See PREVITS & MERINO, *supra* note 22, at 207 ("[C]ircumstances must rule, you have to have experience, that is why we are *professional* accountants." (quoting Arthur Lowes Dickinson)) (emphasis added).

278. See PREVITS & MERINO, *supra* note 22, at 208 ("Early practitioners believed that, because of the vastly different circumstances encountered in the business world, accounting practice was best viewed as an art").

279. *Id.*

280. See Green, *supra* note 243, at 376 (discussing the need for experience and the definition of expertise, including the minimal amount of experience required to be an expert).

281. See PREVITS & MERINO, *supra* note 22, at 208-09 (discussing the emergence of the "adaptive theory").

282. *Id.* at 177 (citing JOHN DEWEY, HUMAN NATURE AND CONDUCT (1922)).

profession realized they were in desperate need of a theoretical grounding for their profession, especially as they sought to formalize accounting's educational requirements. The important works in accounting, until 1908-09, were of English origin, and as one accounting teacher observed: "We not only do not possess a body of accounting literature that could be called American, but if we enquire in some of our libraries or book stores for accounting books we generally receive the answer, 'You mean bookkeeping books.'"<sup>283</sup> This, of course, confirmed that their progress in influencing the public about the need for, or even distinction or existence of, professional accountants had not been great. Even as accounting struggled to find a theoretical basis, it also found political means through which accountants could secure the success and distinction they had been seeking.

Most accountants of the time were deeply opposed to government intervention in financial matters.<sup>284</sup> Some, including the very influential and formidable Elijah Watt Sells, were very outspoken about their opposition.<sup>285</sup> Apparently seeing no irony, however, these same accountants had long sought to become "an *accredited* profession," succeeding with the 1896 passage of the first state CPA law in crucial New York State, followed by eight other states over the next decade.<sup>286</sup> The passage of the New York CPA law led to efforts to secure "similar legislation in the remaining states [that] would preoccupy accountants" for twenty-five years.<sup>287</sup>

Just like today, various financial crises spurred criticism of accountants even as they were emerging as a profession. Failures of large "trusts" (holding companies) provoked "outcry for more direct government supervision of corporations,"<sup>288</sup> but proposed legislation to pass a federal corporate law, and a right to inspect books, was repeatedly defeated in numerous congressional years between 1903 and 1930.<sup>289</sup> The panic of 1907, when New York banks lost over \$12 million in just three days, presented itself as an opportunity for accountants to seize upon "a political environment favorable to further regulation," and a *Journal of Accountancy* editorial declared: "Publicity [of financial statements] is a safe and conservative remedy for most corporate abuses. The certified public accountant is the authorized agent of publicity."<sup>290</sup> Thus, for all of

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283. CAREY, Vol. 1, *supra* note 12, at 101-02.

284. PREVITS & MERINO, *supra* note 22, at 186.

285. *See id.* at 186-87 (discussing Watt Sells's pamphlet that was hostile to government intervention in the free market).

286. CAREY, Vol. 1, *supra* note 12, at 44-45.

287. PREVITS & MERINO, *supra* note 22, at 188.

288. *Id.* at 183.

289. *Id.* at 186.

290. CAREY, Vol. 1, *supra* note 12, at 54-55.

accounting's anti-government rhetoric, they were not so principled as to not join in criticism, or seek to secure their own interests, especially following crisis.<sup>291</sup>

In an era of progressive political change, “[a]ccountants had to provide an institutional framework if the profession was to respond effectively to contemporary demands.”<sup>292</sup> Pragmatism was the intellectual bridge between progressive government and progressive accounting: “Pragmatism gave philosophic justification to political reforms and had a decided impact on the evolution of accounting theory, educational standards, and ethics.”<sup>293</sup> The need for a theoretical foundation--replacing “rationalization” with logic--led to “integrative theory.”<sup>294</sup> In formulating an overarching theory of the nature of accounting, “[a]ccounting theorists faced a formidable task: they had to reconcile traditional accounting profit measurement, based on individualistic economic theories, with an emerging corporate economy.”<sup>295</sup>

Pragmatism has lost much of its influence and appeal in accounting today, but a return to pragmatism's emphasis on experience and perspective may again be helpful to debates about accounting. There are multiple ways to see the world, and multiple methods may be “generally accepted.”<sup>296</sup> “[G]eneral acceptance,” then, “may be a necessary though not a sufficient, requirement for accounting principles.”<sup>297</sup>

One area outside business and political debates that pragmatism also influenced was art. Accountants had long asserted that their craft was an art, so it made perfect sense for them to also embrace this side of philosophic pragmatism.

### iii. Accounting as an Art

If pragmatism's ultimate lesson was that even truth was phenomenally relative, then art was surely relative. And if accounting was an art then it, too, was relative. To the accountant a single definition, borrowed from the pragmatists, could be used to describe both art and accounting since, they

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291. See generally, PREVITS & MERINO, *supra* note 22, at 183-87 (discussing accountants' demands for more corporate oversight in the 1890s and early 1900s); CAREY, Vol. 1, *supra* note 12, at 53-70 (discussing accountants' reactions to federal regulation during times of panic).

292. PREVITS & MERINO, *supra* note 22, at 187.

293. *Id.*

294. *Id.* at 209.

295. *Id.* at 210.

296. See MYDDELTON, *supra* note 7, at 114 (asking two rhetorical questions: “Does the desire for general acceptance mean that accounting standards allow too many alternatives;” and “But is there only *one* way to interpret the world?”).

297. *Id.*

essayed, accounting *is an art*: “[T]he power of performing certain actions especially as acquired by experience, study or observation.”<sup>298</sup>

Specialized knowledge and experience, along with educational standards and requirements, were areas where professional accountants had already been trying to establish widespread acknowledgement among the public of their superiority. These are also said to be elements which distinguish “a true profession . . . from other pursuits.”<sup>299</sup> A former AICPA officer, writing the history of the organization, claimed that “certified public accountants can fairly claim to be the only true profession in the field of finance and management.”<sup>300</sup> If experience and study were elements of *both professionalism and art*, then accountants had found the philosophy that they wanted in pragmatism.

Even today’s accountants face difficult decisions in which judgment, not economic or financial modeling, guides them to recognize events in particular periods, and to decide where and how to classify events in the financial statements, and under what type of valuation method.<sup>301</sup> Some have even suggested that there are no errors in accounting, just estimates that lead to inevitable misstatements, to be reversed in response to new information.<sup>302</sup> Most would contend that judgment has an important role in the process of making estimates and adjustments, even if they have a somewhat narrower view of accounting generally. “Accounting is an art not a science, and *trying to outlaw thinking and imagination would cripple the profession*. Restricting company accountants and auditors to checking compliance with rules is *like requiring real artists, childlike, to paint by numbers*.”<sup>303</sup>

Every entity faces different circumstances which affect its operating environment and its outlook. Because of the need to choose between alternatives in light of these circumstances, early practitioners were adamant in their portrayal of accounting as an art.<sup>304</sup> Even though accounting has experienced a significant modern transformation to more scientific valuation techniques,<sup>305</sup> at least some vestige of “accounting as art” has completely permeated the way we conceive the field: financial statements as pictures (photographs and cinema), the subject of the next two sections.

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298. PREVITS & MERINO, *supra* note 22, at 208.

299. CAREY, Vol. 1, *supra* note 12, at 3.

300. *Id.*

301. KING, *supra* note 74, at 101.

302. *See Id.* at 1-2 (attributing these statements to King’s first accounting professor, the highly influential George Sorter at NYU).

303. MYDDELTON, *supra* note 7, at 99 (emphasis added).

304. PREVITS & MERINO, *supra* note 22, at 208.

305. *See generally* KING, *supra* note 74, at 89-101 (describing the history of accounting).



## iv. Financial Reporting as a Picture: Accounting and Photography

“The balance sheet presents a *snapshot* of a company’s financial position at a point in time.”<sup>306</sup> “The balance sheet is like a *snapshot* of an entity at a specific date. It is intended to reflect the financial condition of that entity as of that specific date.”<sup>307</sup>

We certainly may be right to expect the accountant to present blemishes, but is “touched up” financial data any less a true representation of a corporation than a portrait is of its subject, where the portrait made the person look slightly better than they actually did at the time? Is accounting of greater importance than a portrait, or is there a difference in kind when making this comparison? I do not intend to defend here the removing of blemishes from either financial statements *or* portraits, and I also realize that I am stretching the accounting-is-photography metaphor to its extreme—indeed, I intend to. But the fundamental issue is the same in each case: at what point do superficial changes distort the truth of the representation? And, importantly, “while ‘smoothing’ is now out of fashion it does allow managements to give some emphasis to longer-term trends.”<sup>308</sup> Thus, while earnings management may be a deliberate manipulation, it is not necessarily nefarious and may reflect a more accurate long-term vision which “contrasts with the short-termism of annual accounts (and the even shorter-termism of quarterly reports).”<sup>309</sup>

Like financial statements, “[p]hotographs furnish evidence. Something we hear about, but doubt, seems proven when [we are] shown a photograph of it.”<sup>310</sup> Just like the photograph, we may let accounting’s seeming accuracy and precision allure us into believing its absolute truth:

While a painting or a prose description can never be other than a narrowly selective interpretation, a photograph can be treated as a narrowly selective transparency. But despite the presumption of veracity that gives all photographs authority, interest, seductiveness, the work that photographers do is no generic exception to the usually shady commerce between art and truth.<sup>311</sup>

Under this description, then, accountants risk exposing their own “shady commerce between art and truth” by insisting on the science of their enterprise. Even if accounting were able to be scientific and objective, it

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306. PAUL D. KIMMEL, JERRY J. WEYGANDT, & DONALD E. KIESO, FINANCIAL ACCOUNTING: TOOLS FOR BUSINESS DECISION MAKING 52 (2d ed., 2000).

307. CUNNINGHAM, *supra* note 20, at 10 (emphasis added).

308. MYDDELTON, *supra* note 7, at 117.

309. *Id.*

310. SUSAN SONTAG, ON PHOTOGRAPHY 5 (1977).

311. *Id.* at 6.

would not be free from the problems of perspective.

Perspective is an important element of both photography and accounting. Paton's entity theory of accounting was built around the idea that accounting and accountants have a definite point of view: "The accountant looks upon business operations essentially *through the eyes of the particular group of managers and owners.*"<sup>312</sup> How much of a practical difference does perspective make in reporting on business operations? A lot, at least according to Paton: "It is a point of view in marked contrast to that of the economist . . . and in this contrast lies the chief explanation of the difference between accounting and economic categories."<sup>313</sup> Susan Sontag's description of photographs' point of view applies, in the spirit of Paton, equally to financial statements:

Photographs had the advantage of uniting two contradictory features. Their credentials of objectivity were in-built. Yet they always had, necessarily, a point of view. They were a record of the real—incontrovertible . . . since a machine was doing the recording. . . . The truth is they are not "simply" anything, and certainly not regarded just as facts.<sup>314</sup>

So what of this link, this metaphor, this similarity between accounting and photography? And what of this matter of perspective and objectivity? I would suggest that accountants, in trying to appear reputable and unbiased, have placed too much emphasis on creating and maintaining a façade of objectivity, effectively eschewing the inescapable influence of perspective. Accountants used to emphasize the need for judgment, along with their expertise in providing it. Today, though, both accountants and photographers<sup>315</sup> purport to be mere reporters, conveying a simple truth. Like photographers, who often purport to "take" (passively, instead of "make") photographs,<sup>316</sup> too many accountants today wish to be--or at least claim to be--engaged in a similarly passive enterprise. Yet snapshots can be misleading precisely because their accuracy, however great it may be, is fleeting. "The balance sheet is a 'snapshot' at a moment in time. But in most ongoing businesses annual accounting bears no relation to the business cycle."<sup>317</sup>

Perspective, however, may be of even greater importance to accounting today than in Paton's time. Intangibles, as discussed in section III.A.iii, *supra*, present true dilemmas for financial statement presentation.

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312. PATON, *supra* note 235, at 17 (emphases added).

313. *Id.*

314. SUSAN SONTAG, REGARDING THE PAIN OF OTHERS 26 (2003).

315. This is especially true in news media depiction of graphic and violent acts. *See generally id.* (discussing the portrayal of war through photographic images).

316. *Id.* at 46.

317. MYDDELTON, *supra* note 7, at 119.

Accountants' judgment, then, is presumably even more important in this context, yet accountants seek ever more "objective" presentation, notwithstanding its dissonance with economic reality.<sup>318</sup> The U.S. Supreme Court recognizes that "GAAP . . . does not necessarily parallel economic reality."<sup>319</sup> Or as Olumfunmilayo Arewa said: "As a result of the intangibles paradigm shift, financial statements have become less informative from an accounting and economic perspective."<sup>320</sup>

Perspective (or subjectivity) in accounting was not always considered a bad thing. Allowing for multiple, competing visions actually makes accounting more vibrant. Plurality leads to evolution that facilitates accounting keeping up with an ever-changing business environment.<sup>321</sup> Experience and judgment can properly lead accountants to new and different presentation of information, and "deviation from conformity with existing norms sometimes reflects useful innovation rather than harmful obfuscation."<sup>322</sup>

How then, in the wake of accounting scandals and economic crises, might accounting reclaim the good of perspective, the need for judgment? That is the topic of the next section.

v. Disclosures: Can Accounting be More Cinematographic than Photographic?

"The income statement is like a *motion picture* of the enterprise over a defined period of time, such as one year, and is intended to reflect the financial performance of the entity during that period of time."<sup>323</sup>

The "photographic paradox" is its simultaneous literalness and the added meaning ("message") of what it shows us.<sup>324</sup> But the photograph is also bounded, framed by a border. Cinema, however, allows the viewer to transcend, at least to some degree, such limitations:

The photographic image is full, crammed: no room, nothing can be added to it. In the cinema, whose raw material is photographic, the image does not, however, have this completeness (which is fortunate for the cinema). Why?

318. See *supra* Part III.A.i (discussing the expensing of stock options).

319. *Shalala v. Guernsey*, 514 U.S. 87, 100 (1995).

320. Arewa, *supra* note 14, at 45.

321. See MYDDELTON, *supra* note 7, at 111 ("More than one accounting practice may be 'generally accepted' at any one time. If it were not so, how could accounting evolve?").

322. MACEY, *supra* note 32, at 156.

323. CUNNINGHAM, *supra* note 20, at 11 (emphasis added) (emphases omitted).

324. See ROLAND BARTHES, *IMAGE, MUSIC, TEXT 17* (Stephen Heath trans., 1977) ("By definition, the scene itself, the literal reality. From the object to its image there is of course a reduction--in proportion, perspective, colour . . . . [I]t is a message without a code . . . . [T]he photographic message is a continuous message.").

Because the photograph, taken in flux, is impelled, ceaselessly drawn toward other views; in the cinema, no doubt, there is always a photographic referent, but this referent shifts, it does not make a claim in favor of its reality, it does not protest its former existence; it does not cling to me: it is not a *spectator*.<sup>325</sup>

Thus the cinema allows us--forces us--to recall that there is more to the scene, that there is action outside the frame, and this makes it less likely that we are fooled by the literalness of the photographic paradox.

What does all this talk of photography and cinema have to do with accounting? If we see financial statements as photographs, why not as cinema? Like photography, accounting has sought, in many ways, to present its subject as literal truth, passively captured, and free of bias. Yet again, just like photography, this is simply half-truth, and one half of the literal-subjective paradox that is inherent to photography. *Accounting's precision belies its fallibility*. If cinema is advantageously lacking the "completeness" of the still photograph, forcing us to acknowledge its limits, then why could--or should--accounting not do likewise? In fact, financial statements have long done just that, through disclosures--notes to the financial statements.

Notes to the financial statements should remind us of the statements' own, sometimes steep, limitations. Financial statements are generally accompanied, on each page, with "*notes are an integral part of the financial statements*" boilerplate, but this generic statement truly ought to remind us that the notes after the statements *are* part of the story, and maybe a very big (or even the largest) part of the financial condition. We might think of this financial statement boilerplate as the equivalent of the "*this movie is a dramatization of actual events*" boilerplate in docudramas and biopics. Both types of messages remind us that we are seeing one version of the story, but that certain facts may be omitted, disputed, glossed over, or subject to different interpretation than with which we are presented. On the whole, this is a useful and important reminder.

Olufunmilayo Arewa has previously advocated increased disclosure standards, writing about accounting for intangibles:

Current accounting practices and procedures as embodied in GAAP do not adequately measure intangibles or sufficiently contemplate the implications of the intangibles paradigm for existing measurements. . . . Additional disclosure about intangibles would, however, improve the accuracy of financial statements' representations of economic reality and provide additional information that may help minimize opportunities for fraud that currently exist with respect to intangibles paradigm

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325. ROLAND BARTHES, CAMERA LUCIDA: REFLECTIONS ON PHOTOGRAPHY 89 (Richard Howard trans., 1980).

discourse and company framing. This would in turn help make financial statements more transparent and reliable.<sup>326</sup>

The SEC, too, has recognized that the notes to the financial statements can offer increased understanding and transparency of the underlying data. In its 2008 report on fair value accounting, the Chief Accountant's Office recommended the introduction of "*a new schedule (to be included in the notes of the financial statements)* that would reconcile cash flows to comprehensive income."<sup>327</sup> This new statement "would be helpful because users have asked for information to help them understand how components of accrual accounting affect an entity's comprehensive income and future cash flows."<sup>328</sup> More generally, the SEC has also noted that financial statement users and producers have each highlighted the value of increasing disclosures, including sensitivity analyses, projections of future values, and detailed discussion of both the inputs and valuation techniques employed in the financial statements.<sup>329</sup> Regardless of the specificity of standards, increased disclosures allow users to select and analyze the data they believe to be valuable.

Although, as shown in Part III.A., perfect *valuation* may be impossible, disclosure goes a long way to ameliorate the problems of *choosing among competing valuations*. By disclosing alternatives and the facts underlying circumstances, users may (and are exhorted to) use the conditions *they deem relevant* in assessing the company's overall financial condition. While Arewa has shown the great need for more robust disclosure pertaining to intangibles, it applies equally to every area of valuation in accounting, including the infamous fair value standards.

### C. FAS 157 and Fair Value Accounting

SFAS No. 157 does not itself require mark-to-market or fair value accounting. Rather, other accounting standards in various ways require what is more broadly known as "fair value" accounting, of which mark-to-market accounting is a subset. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles ("GAAP"), and requires expanded disclosures about fair value measurements.<sup>330</sup>

Various government regulators, including the Office of the Controller of the Currency, acknowledge that fair value, while not perfect, is better

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326. Arewa, *supra* note 14, at 95.

327. 2008 SEC Report, *supra* note 11, at 198 (emphasis added).

328. *Id.*

329. *Id.* at 151.

330. 2008 SEC Report, *supra* note 11, at 1 (emphasis added).

than its alternatives: “[F]air value[] provides the best estimate of the value of many types of financial instruments as of the measurement date. ‘While additional steps can and should be taken to enhance existing standards, the OCC believes that it is inappropriate to suspend current fair value measurement.’”<sup>331</sup> Yet there remains a tremendous outcry to repeal fair value standards.

Often portrayed as a single and very recent accounting change, “fair value” actually refers to a broad spectrum of accounting methods that have been long-debated and that were implemented largely in response to earlier financial scandals and crises, as discussed in section i of this Part. Section ii distinguishes mark-to-market accounting from fair value accounting, and discusses why mark-to-market might actually be a misapplication of fair value accounting for some companies in recent reporting quarters. Section iii frames the problem of finding alternatives to fair value.

#### i. History of and Reasons for Fair Value Accounting

John Poirier, then the SEC’s Acting Chief Accountant, offered the following as part of his 2009 testimony before Congress about mark-to-market accounting:

Previous generations, after considering the causes of financial crises experienced during their times, concluded that fair value accounting was an important tool to communicate investment values to capital market participants. In particular, fair value was chosen after careful consideration, including consideration of the causes of previous financial crises and the tools that would best equip future generations when crises reemerged, such as we find ourselves in today.

Although the use of fair value dates back many decades, the use of fair value measurement expanded significantly in 1975 due to concerns about the appropriate measurement attribute for securities. . . .

The banking and savings and loan crisis of the 1980s further exposed challenges to the historic cost model of accounting for financial institutions. Specifically, savings and loan institutions accepted short-term deposits and used these deposits to fund long-term fixed-rate (e.g., 30-year) mortgage loans, their primary asset. In the late 1970s and early 1980s, interest rates were driven up by high inflation. As a result, the “current value” of

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331. John Poirier, *U.S. regulator opposes suspending mark-to-market*, REUTERS, Mar 11, 2009, <http://www.reuters.com/article/ousiv/idUSTRE52A7B020090311> (quoting Kevin Bailey, deputy comptroller of the currency).

assets in many cases was significantly less than the value of many reported liabilities, and these institutions were economically insolvent. However, under the historic cost accounting model, these losses were often not reflected in financial statements, which reduced transparency about their solvency.<sup>332</sup>

While this history is correct and well substantiated,<sup>333</sup> and although it stands in stark contrast to media reports and commentary that fair value is new, even Poirier's history is greatly abridged and unduly contemporary in its focus. While some of this history was already discussed,<sup>334</sup> here, I shall elaborate (although still not comprehensively) on the length and nature of the pre-1975 debate that brought us to fair value accounting standards.

Financial records have existed in some form for at least 4000 years<sup>335</sup> and ancient philosophers grappled with the notion and problems of value in both exchange and wealth.<sup>336</sup> Double entry bookkeeping dates to at least 1299 AD,<sup>337</sup> and must surely have included questions of valuation among its earliest users. In terms of valuation leading to financial crises and eventual government response, an early and well-documented case is the South Sea Bubble of 1720. Over approximately one month, the South Sea Company's stock plummeted from £900 (having once been £1050) to £190 per share in a panic where investors, fearing total loss, caused a run on and the failure of the company, with Parliament ultimately passing an act rescinding corporate charters in the absence of the monarch's personal approval.<sup>338</sup> This marked a suspension of "[t]he corporation as a common

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332. *Testimony Concerning Mark-to-Market Accounting: Practices and Implications: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 111th Cong. (Mar. 12, 2009) (statement of James L. Kroeker, Acting Chief Accountant of the U.S. Securities and Exchange Commission), available at <http://www.sec.gov/news/testimony/2009/ts031209jlk.htm> (emphases added) (footnote omitted).

333. See, e.g., *supra* Part III.A.

334. *Id.*

335. THOMAS R. MARTIN, *ANCIENT GREECE: FROM PREHISTORIC TO HELLENISTIC TIMES 24-25* (Yale Nota Bene 2000) (1996) (discussing evidence of accounting records dating to at least the ancient Minoans of approximately 2000 B.C.).

336. Whether one sees the ancient economy as similar to, analogous to, or very different from the modern concept of economics and finance, it is clear that many issues were of common concern then and now. See M. I. FINLEY, *THE ANCIENT ECONOMY* (1973) (discussing the concept of finance and economics primarily in ancient Greece and the Roman Empire and arguing that although they had similar material concerns, the ancients were ultimately more concerned with status and self-sufficiency than economics in the modern sense). *But see* WALTER SCHEIDEL AND SITTA VON REDEN, *THE ANCIENT ECONOMY* (2002) (examining how well the Finley thesis has lasted in the subsequent decades).

337. PREVITS & MERINO, *supra* note 22, at 3.

338. *Id.* at 23.

business form.”<sup>339</sup> The corporate form had become popular to spread risk during periods of extensive colonization, beginning with corporate charters for English trade companies dating back to failed Roanoke in 1585 and the profitable East India Company in 1600.<sup>340</sup> These early capital markets fueled many successful ventures, but the South Sea Bubble renewed desire for conservatism, skepticism of capital asset valuations, and also spurred the creation of the public accounting profession.<sup>341</sup>

Soon after independence, America’s capital markets began to be regularized in 1792, when merchants and auctioneers met on Wall Street to establish consistent securities trading practices--no longer unorganized in various coffeehouses, but during prescribed hours under a nearby buttonwood tree.<sup>342</sup> By the 1830s, however, some were concerned by the number of bank failures.<sup>343</sup> Yet general corporation laws were taking hold around the growing nation and accountants were finding employment, especially in banks, as burgeoning capital markets fueled expanded capacity and risk taking.<sup>344</sup> And these accountants were forced to confront the problem of valuation.

Although some had sought to establish theoretical concerns in accounting as early as the sixteenth century,<sup>345</sup> accounting was mostly the product of practical, not theoretical, concerns. That is, until the movement in the early twentieth century to create a dominant theoretical framework for the profession in the U.S; which is not to say, however, that practical problems--especially valuation--were not of profound significance, or that these issues went completely unrecognized. Throughout the creation and expansion of capital markets and businesses in the U.S., “the engine of corporate capitalism would begin to generate demand for expert financial and accounting advice.”<sup>346</sup> Failures would invite blame, but accountants kept on, if unwittingly, developing the groundwork of competing theories of valuation.

It was observed during this time, for instance, that Americans defined personal wealth as capital accumulation, *i.e.*, net worth, while the English defined wealth in terms of income.<sup>347</sup> Whether American accountants caused, contributed to, or simply responded to this phenomenon is debatable, but accountants certainly faced the problems of asset valuation,

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339. *Id.*

340. *Id.* at 15.

341. *Id.* at 24.

342. *Id.* at 40.

343. *Id.* at 41.

344. *Id.* at 41-42.

345. *Id.* at 222.

346. *Id.* at 61.

347. *Id.* at 215.



regardless of the cause of its growing emphasis in America.<sup>348</sup> After over 100 years of rapid growth, by 1900 there was widespread and growing concern about misleading, inflated capital asset valuation by the promoters of securities.<sup>349</sup>

Even while questions of valuation grew more important, accountants struggled not only over how to value assets, but what assets were in the first place.<sup>350</sup> Related to this was a concern that went directly back to capital markets: the proper level of capitalization, *i.e.*, stock value versus asset value.<sup>351</sup> This formative period was also when accountants began to move towards some consensus that “some departure from [historical or original] cost was essential if the balance sheet was to reflect the ‘true financial condition,’” as through depreciation and amortization.<sup>352</sup>

Panics in 1837, 1842, 1857, 1874, and 1893<sup>353</sup> no doubt further shook confidence in valuation. However, it was the panic of 1907, noted already, that served most conveniently for the emerging and still-formalizing public accounting profession to argue for reform, as well as its own expertise in financial reporting.<sup>354</sup> Although CPAs had limited success in these efforts, the wake of 1929’s monumental crash opened wide the regulatory door through which the profession would transform itself.

The years between 1907 and 1929 are important to valuation theory because this is when accounting was seeking to formulate its theoretical foundations, and valuation was of central importance to this effort. This included, in its broadest terms, Paton arguing entity theory against pure proprietary theory.<sup>355</sup> More specifically, seminal debates included contests over the dollar as a unit of measurement (~1918);<sup>356</sup> par versus no-par stock and the earnings accounting manipulations possible under each (~1917-28);<sup>357</sup> and even the valuation of intangibles (~1922).<sup>358</sup>

Throughout these formative years of the modern U.S. economy and financial system, a variety of valuation techniques were in active use, including historical cost, replacement cost, and “price-level” (a form of fair value) accounting.<sup>359</sup> Although historical cost would come to experience

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348. *Id.*

349. *Id.* at 216.

350. *Id.* at 216-17.

351. *Id.* at 216.

352. *Id.* at 218.

353. *See id.* at 67, 69, 72, 96, 109, 111, 182 (noting these episodes).

354. CAREY, Vol. 1, *supra* note 12, at 55-56.

355. “The emphasis of this treatise . . . lies in a revision of the broad outlines of the proprietary theory of accounts.” PATON, *supra* note 235, at iv.

356. PREVITS & MERINO, *supra* note 22, at 262.

357. *Id.* at 263-64.

358. *See* PATON, *supra* note 235, at 307-32 (dedicating a whole chapter to discussion of goodwill and other intangibles).

359. PREVITS & MERINO, *supra* note 22, at 267.

somewhat greater prominence, but never exclusivity, its problems became more apparent after it contributed to significant economic problems, eventually leading to the renewed use of fair value in the 1970s and 1980s, as discussed above by SEC Acting Chief Accountant John Poirier.

Current accounting standards compel both fair value and historical cost accounting, in different circumstances, under the “mixed-attribute model.”<sup>360</sup> Some assets, for instance, are commonly valued at the lower of cost or fair, *i.e.*, market, value; thus, both valuations are maintained by the reporting entity, yet potentially reported differently in different periods, making the asset valuation incomparable across periods.<sup>361</sup>

Like fair value, historical cost accounting is not a single method, but a range of possible methods, all of which are anchored in, but also depart from, simply recording historical prices. Nor does historical cost accounting necessarily promote comparability because of differences in when cost was measured (*e.g.*, \$50 in 1950 is quite different from \$50 today), different impairment testing or calculation and artificial (if still justifiable) adjustments such as depreciation and amortization, which may themselves be calculated in various ways.<sup>362</sup> Further, historical cost is susceptible to general price fluctuations between or even within periods. We generally think of this as inflation, but it may also work in the opposite direction, as when assets were “in effect being *written up* by deflation” between 1875 and 1900.<sup>363</sup> Nor is it obvious that historical cost reflects actual economic conditions. Depreciation is applicable only to historical cost accounting, yet “[d]epreciation accounting offered no help to managers when buying or replacing machines,” especially during periods of rapid innovation and obsolescence, as occurred during the first half of the twentieth century, even as depreciation began to become accepted among the profession.<sup>364</sup>

Both “historical cost” and “fair value” accounting refer to a range of valuation methods. Neither is absolutely better than the other, or free of subjectivity. One rampant misconception is that mark-to-market accounting is synonymous with fair value accounting, instead of being a subset thereof. That misconception is what the next section seeks to disabuse. Instead of being the definition of fair value accounting, mark-to-market is but one point along the fair value spectrum.

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360. SEC Report, *supra* note 11, at 27.

361. *Id.*

362. *Id.* at 27.

363. PREVITS & MERINO, *supra* note 22, at 125 (emphasis in original).

364. *Id.* at 163.

ii. Contemporary Standards: Fair Value was Never (Necessarily) Mark-to-Market

Two points are a necessary preface to a discussion of current fair value accounting standards: (1) FAS 157 does *not* create, establish, mandate, expand, or otherwise instantiate fair value accounting, it merely clarifies the standards already in effect; and (2) mark-to-market accounting is a subset of fair value accounting, and is not compelled under all circumstances as the calculation of fair value. I shall soon elaborate on these points, but turn quickly first to a discussion of the recent history and existing landscape of fair value accounting.

Valuation, as discussed in the last section, was a perennially contested idea in the twentieth century. Persistent inflation following World War II served to spur further debate, especially from the 1960s onward.<sup>365</sup> There are two dimensions of this debate: specific valuation techniques, *i.e.*, cost or value, and the relative importance of particular financial statements, *i.e.*, balance sheet or income statement.<sup>366</sup> Thus one can reach conclusions by way of theory of valuation, on the basis of the importance of an individual financial statement, or some combination of both. The mixed-attribute model of U.S. financial reporting in turn reinforces the value of an *integrated set* of financial statements, where no single statement is inherently privileged.<sup>367</sup>

The upward valuation of assets had been quite common during the 1920s, but was “virtually extinct” by 1940 on the basis that such write-ups were “arbitrary,” especially in the typical cases of using *appraised* values for fixed assets and intangibles.<sup>368</sup> The valuation of securities, however, had by the 1970s proved to be sometimes drastically unrealistic where trading values were far below original cost.<sup>369</sup> Unclear guidance, specifically as to whether firms that had written down securities which had now recovered their value could now write them back up, prompted the FASB to issue SFAS No. 12, *Accounting for Certain Marketable Securities*, in December 1975.<sup>370</sup> This statement clarified that all marketable securities were to be valued at the *lower of cost or market* values.<sup>371</sup> Reaction to the savings and loan crisis, interest rate deregulation

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365. PREVITS & MERINO, *supra* note 22, at 384.

366. *Id.*

367. The income statement's death to the balance sheet has long been predicted, as has the demise of both of them to the statement of cash flows, yet no single statement has actually been crowned ruler by analysts. *See id.* at 384-85, 387.

368. SEC Report, *supra* note 11, at 34-35.

369. *Id.* at 35.

370. *Id.* *See also* SFAS 12 *Accounting for Certain Marketable Securities* (indicating it is now fully superseded by SFAS No. 115, ¶ 124).

371. *Id.*

in the 1980s, increased use of derivative financial instruments in the 1990s, and numerous other factors led to a hodge-podge of additional statements mandating or allowing for fair value accounting.<sup>372</sup>

By September 2006, when FAS 157 was issued, there was a desperate need for clarification of the numerous standards calling for or otherwise affecting the practice of fair value accounting.<sup>373</sup> All told, FAS 157 amended or superseded four APB opinions, thirty-seven FAS Statements, and numerous other formal interpretations and other documents.<sup>374</sup> FAS 157, instead of mandating a major change, clarified 35 years of prior, confusing, and sometimes conflicting statements about fair value accounting, which had been used in various ways throughout that period of time. FAS 157 “only provides guidance on *how to estimate fair value*,” and is *not* a statement that requires it.<sup>375</sup> To repeal FAS 157 would not roll back the requirement of fair value accounting, but merely remove the guidance on how to go about determining it.

Mark-to-market accounting, almost uniformly vilified of late, is not a requirement of FAS 157 either, nor is it synonymous with fair value. “SFAS No. 157 does not itself require mark-to-market or fair value accounting. Rather, *other accounting standards in various ways require what is more broadly known as ‘fair value’ accounting, of which mark-to-market accounting is a subset.*”<sup>376</sup> Although FAS 157 establishes a hierarchy of valuation techniques, at which “quoted prices (unadjusted) in active markets” are given primacy as “Level 1 inputs”<sup>377</sup> it is not clear that so-called “toxic” assets’ markets have truly been active and, in any case, “[c]ompany-specific information should be factored into fair value measurement when relevant information is not observable in the market,”<sup>378</sup> including “the company’s expectation regarding market participant assumptions.”<sup>379</sup> FAS 157 makes abundantly clear that, while market prices are preferred, they may not always be the best source of fair value: “A quoted price in an active market provides the most reliable evidence of fair

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372. 2008 SEC Report, *supra* note 11, at 35-38.

373. See SFAS 157, *Reason for Issuing This Statement* (noting that “prior to this statement there were different definitions of fair value and limited guidance for applying those definitions in GAAP” and that “these differences created inconsistencies that added to the complexity of applying GAAP.”).

374. *Id.* at 87-145 (detailing the documents SFAS 157 affects). See also Status of Statement No. 157, <http://www.fasb.org/st/status/statpg157.shtml> (listing current status of 157 documents).

375. 2008 SEC Report, *supra* note 11, at 3.

376. *Id.* at 1 (emphasis added).

377. Fin. Acct. Standards Board, Statement of Fin. Acct. Standards No. 157, Fair Value Measurements, at FAS157-11 ¶ 22.

378. 2008 SEC Report, *supra* note 11, at 23.

379. *Id.* at 51.

value . . . .”<sup>380</sup> *But*, “fair value may be measured using an alternative pricing method . . . as a practical expedient,”<sup>381</sup> and “[i]n some situations, a quoted price in an active market might not represent fair value at the measurement date.”<sup>382</sup>

Although FAS 157 is widely criticized, it is for clarification purposes and its suspension would merely remove the guidance it offers on fair value measurement and disclosure, without removing the extant requirements to use fair value accounting already “embedded in numerous other standards.”<sup>383</sup> Moreover, within this guidance are details and examples of the many circumstances in which fair value accounting will not equate to mark-to-market accounting. The SEC explicitly chastised, *inter alia*, the misinterpretations of FAS 157 to require mark-to-market accounting, especially in distressed markets, as financial institutions have faced since late 2007:

From the various recent public dialogues over fair value accounting, one area of concern appears to be a possible lack of understanding surrounding the concept of “fair value” and its application in the accounting literature. For example, in addition to a misconception among some that SFAS No. 157 itself requires fair value accounting, *other misconceptions are that the requirements in SFAS No. 157 apply only to instances where a market price cannot be determined, or that SFAS No. 157 requires preparers to use observable prices in inactive or disorderly markets, neither of which is accurate.*<sup>384</sup>

No markets could better be described as “inactive or disorderly” than the markets for securitized mortgages in 2008, yet many continued to interpret FAS 157 to require market valuations.

It is also important to remember the extent to which fair value is used, and this is far less than many reports would lead us to believe. Even in financial institutions (which have more items subject to fair value accounting than most entities do) “less than a majority of assets and liabilities” are subject to fair value, and “a significantly smaller population of instruments” are valued with mark-to-market methods.<sup>385</sup> Ultimately, it appears that “fair value accounting was not a primary underlying cause of the 2008 bank failures” and even in “failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was

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380. Statement of Fin. Acct. Standards No. 157, *supra* note 378, at FAS157-11 ¶ 24.

381. *Id.* ¶ 25.

382. *Id.* ¶ 26.

383. 2008 SEC Report, *supra* note 11, at 171.

384. *Id.* at 172 (emphasis added).

385. 2008 SEC Report, *supra* note 11, at 43.

the reason the bank failed.”<sup>386</sup> Instead of *accounting* leading to massive devaluation, it is more likely that “the marketplace factored in losses for these banks that *had not been recognized in U.S. GAAP reported income*.”<sup>387</sup>

iii. Alternatives to Fair Value?

Even if fair value accounting is in need of repeal, upsetting decades (not months) of accounting standards, we are not left with a clear road to improved accuracy and transparency. If we were to retreat from fair value accounting, the obvious candidate for valuing assets is historical cost accounting. Historical cost, then, is simple and objective to compute, right? Well, first we must consider what *basis* we should use. FASB and IASB have been working together to discuss measurement alternatives, but they do not even use the terms “historical cost” and “fair value” because, according to the SEC, “there is little common understanding of these terms.”<sup>388</sup> It is far more precise to talk of a “time frame” in which to orient measurement: past, present, or future value.<sup>389</sup> Even within a particular time frame, however, we face the question of what *basis* to use, *i.e.*, whether to use entry prices, exit prices, or some sort of modified figure.<sup>390</sup> And even within these choices there may be finer choices to be made, such as whether present entry prices should be based on replacement of identical assets, equivalent assets, assets capable of the same output or capacity, etc.<sup>391</sup>

The problem of using the general terms of historical cost *versus* fair value include that “the same general term can refer to a number of different bases . . . lead[ing] to miscommunication and misunderstanding.”<sup>392</sup> Another problem with discussing historical cost and fair value as different paradigms for financial reporting is that financial reporting in the U.S. simultaneously uses *both* historical cost and fair value.<sup>393</sup> U.S. GAAP is structured to produce an integrated *set* of financial statements, including (1) a balance sheet, (2) income statement, (3) cash flows statement, and (4) changes in equity.<sup>394</sup> As the SEC Report instructs:

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386. *Id.* at 97.

387. *Id.* (emphasis added).

388. 2008 SEC Report, *supra* note 11, at 174.

389. *See id.* at 173-74 (comparing FASB and IASB in various time frames).

390. *Id.*

391. *Id.*

392. *Id.* at 174.

393. *Id.* at 175. *See also* Arewa, *supra* note 14, at 67 (discussing debates over accounting rules over the last century).

394. The amount and variety of information that financial reporting should provide about an entity require several financial statements. FASB Statement of Financial Accounting

Each financial statement provides different types of information, but the statements are interrelated in that they “reflect different aspects of the same transactions or other events affecting an entity,” as well as complementary in that “none is likely to serve only a single purpose or provide all the financial statement information that is useful for a particular kind of assessment or decision.”<sup>395</sup>

A shift to “pure” historical cost or fair value paradigms would undermine the framework of an integrated set of financial statements. A pure historical cost model would give primacy to the income statement, which would convey the value added by the financial statement issuer, while the balance sheet would merely represent the matching of income to its historical costs.<sup>396</sup> On the other hand, a shift to pure fair value reporting would make the balance sheet the most important indicator of value, while the income statement merely captured the changes in balance sheet accounts from year to year.<sup>397</sup> Although it is not simple, the primary virtue of a mixed framework is that it offers four related depictions of the issuer’s underlying economic activity during the period.

#### IV. CONCLUSION

Mark-to-market accounting may be partially responsible for recent fluctuations in asset values but, even if true, these accounting changes came about precisely because historical cost was causing firms to hide bad loans at other times, under different circumstances.<sup>398</sup> What are we to make, then, of the current financial crisis and accounting’s alleged role in it? Something does not make sense. “Maybe the banks are just counting wrong”<sup>399</sup> after all. But what “regulator” is responsible for telling the banks of their *accounting* errors?

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Concepts (SFAC) No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* 14 (1984). A full set of financial statements for a period should show: (1) financial position at the end of the period, (2) earnings (net income) for the period, (3) comprehensive income (total non-owner changes in equity) for the period, (4) cash flows during the period, and (5) investments by and distributions to owners during the period. *Id.* Information about earnings, comprehensive income, cash flows, and transactions with owners have in common that they are different kinds of information about the effects of transactions and other events and circumstances that change assets and liabilities during a period. *Id.* See also SEC Report, *supra* note 11 at 16 (referencing SFAC No. 5, ¶¶ 39-41 and 55-57).

395. 2008 SEC Report, *supra* note 11, at 16 (quoting SFAC No. 5, ¶ 23).

396. *Id.* at 176.

397. *Id.*

398. See Berlau, *supra* note 52, at A15 (discussing how accounting reforms affected the economic crisis that began in 2008).

399. *Id.*

One current problem is that when companies do make write-downs under fair value accounting, the write-down itself triggers further devaluation, like a run on banks, to a point probably much lower than the assets are actually worth. Reactionary legal changes to accounting, however, overlook the underlying problems. The lack of genuine regulation (either market, self, or government) keeps accounting stuck in an ever-deepening cycle of scandal-“reform”-scandal. The attack on fair value accounting is but the most recent chapter of this story, even while it relies on an idealized view of accounting’s precision and objectivity.

A lot of people say fair value accounting (and especially mark-to-market valuation) is terrible, but it is hardly obvious that it is worse than its alternatives. Assuming, *arguendo*, that fair value accounting (instead of a mere bank run, as the SEC contends)<sup>400</sup> did lead, or at least contributed, to financial crisis, we have no idea in what ways other accounting methods would have restructured or exploited incentives and their effects given the same underlying economic conditions. We do, however, know that other accounting methods have contributed to prior financial crises. Yes, fair value accounting brings with it certain problems, but so does historical cost accounting, which is why we have moved toward fair value accounting in the first place.<sup>401</sup>

Accounting also languishes in a state of non-regulation where competing, yet entrenched and sometimes cooperative interests vie for both power and blamelessness. There are three paradigms for regulation: government, self, and market. Accounting suffers because none of these paradigms dominate the industry, which suffers from the worst aspects of each. Accounting and accountants are thus themselves unaccountable, but this is a function of conflicted regulatory interests, not an absence of actors in the regulatory enterprise. Crisis may well be “regulation-blind,” occurring regardless of the regulatory landscape,<sup>402</sup> but we cannot afford to ignore the failed organization of accounting.

Even if a proper regulatory framework were in place, accounting is also far less concrete than most (experts and non-experts alike) believe or hope. This, too, puts accounting in a difficult, if not impossible, position, for it can never live up to the expectations many have for it. Unlike the systemic market perspectives of economics and finance, accounting is inherently individualistic and, as a result, subjective. Instead of trying to hide or eliminate this aspect of accounting, accountants, regulators, and lawmakers should seek to reclaim the role of judgment and artistry in

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400. 2008 SEC Report, *supra* note 11, at 3.

401. Sorkin, *supra* note 2 (noting that the purpose of FAS 157 was to make the market more transparent and efficient).

402. See Galli & Mingardi, *supra* note 178 (making the argument that lax regulation was not the cause of the economic crisis that began in 2008).



accounting, for this is what gives accounting the basis to evolve and remain relevant in light of constantly changing economic operating environments.

No method of accounting is a perfect representation of anything, and this is exacerbated by the fact that even the most sophisticated investors, including institutional investors, have stopped rigorously analyzing data and take the company's financials at face value, instead of mining all the information available in them by digging deep enough.<sup>403</sup> This was true even of Enron, where some had identified looming problems based on the company's financial statements, yet this went largely unnoticed.<sup>404</sup> Accounting is biased and individualistic, not systemic, in its perspective. Acknowledging accounting's limitations takes it off the pedestal of science, but it also points to the need for transparency (through disclosure) more than trumped up rhetoric of precision and objectivity.

Transparency should remain the primary goal of financial accounting. However, the primary mechanism of transparency in financial reporting is not uniform reporting, but robust disclosure requirements. In the absence of rigorous disclosure, even the strictest standards serve only as a shroud, especially as incentives adapt and compliance becomes, inevitably, "creative."<sup>405</sup>

Accounting's low point as a profession (if that is in fact now) is not a function of fair value as a recent and colossal mistake, but a function of poor incentives and bad publicity, largely a function of the profession's own rhetoric of science and objectivity, eschewing its prior (and more accurate) position of judgment and artistry. The result has been an increasingly unrealistic expectation of accounting's truth and objectivity, leading to inevitable disappointment and blame in the wake of accounting problems. On top of this, the conflicted regulatory interests affecting accounting's professional organization lead to a lack of accountability and a glut of blame shifting when the public cries out against the profession. Proposed legislative "reforms" do not address the most fundamental issues of accounting.

Accounting's substance should be less centralized and allow for more diversity in presentation, coupled with increased disclosure requirements. Accounting should focus less on uniformity and more on judgment. Emphasizing accounting's reliance on judgment need not soften public expectations of accountants, but may reintroduce genuine accountability among accountants themselves.

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403. See Macey, *supra* note 48, at 345-46 (discussing the phenomenon of sophisticated investors not investigating accounting data that is provided to them).

404. *Id.*

405. See Cunningham, *supra* note 216, at 1424 (describing what constitutes creative methods of compliance).