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An Argument on Behalf of Pakaluk and Cheffers' Contention

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Abstract

In Professor Baker's review of the book by Pakaluk and Cheffers (2011) he took exception to their contention, implied in the book's title, that accounting ethics contributed to the current financial crisis. Baker's claim is that there is no evidence to support that contention. There have been a number of apologias for the accounting profession with respect to any culpability it might have in bringing the world to the state of financial crisis in which it currently finds itself. The financial crisis itself is evidence for accounting's culpability in the crisis because the profession failed to prevent it. Since the inception of the profession in the United States, at least, the rationale for a profession of accounting has been that sufficient, reliable information would allow financial markets to self-police and lead to some kind of efficient allocation of capital, i.e., accounting functions to lubricate the capital markets and remove the frictions that result from "information asymmetries" and other such bothersome shortcomings inherent in markets. There is ample evidence that the profession has failed in that aspect of its self-proclaimed responsibility and, thus, is indeed partly responsible for the financial crisis. And, I intend to argue, that failure is at least partly a moral failure for which the profession, qua a profession, is responsible.

KEYWORDS: accounting, business ethics, financial crisis, financial scandals

JEL Classification Codes: M42, M41, K40

Comment on Richard Baker's book review of Michel Pakaluk and Mark Cheffers, *Accounting Ethics...And the Near Collapse of the World's Financial System*, Allen David Press, Sutton Massachusetts, 2011.

In Professor Baker's review of the book by Pakaluk and Cheffers (2011) he took exception to their contention, implied in the book's title, that accounting contributed to the current financial crisis. Baker's claim is that there is no evidence to support that contention. There have been a number of apologies for the accounting profession (e.g., Barth and Landman, 2010) with respect to any culpability it might have in bringing the world to the state of financial crisis in which it currently finds itself. The financial crisis itself is evidence for accounting's culpability in the crisis because the profession failed to *prevent* it. Since the inception of the profession in the United States, at least, the rationale for a profession of accounting has been that sufficient, reliable information would allow financial markets to self-police and lead to some kind of efficient allocation of capital, i.e., accounting functions to lubricate the capital markets and remove the frictions that result from "information asymmetries" and other such bothersome shortcomings inherent in markets (Williams, 2011). There is ample evidence that the profession has failed in that aspect of its self-proclaimed responsibility and, thus, is indeed partly responsible for the financial crisis. And, I intend to argue, that failure is at least partly a moral failure for which the profession, qua a profession, is responsible

Professor Baker's exculpation of accounting in the financial crisis is premised on his, correct, contention that accountants have lost jurisdiction over financial reporting. But contrary to his further contention that this loss of jurisdiction was the result of expropriation by the government, quasi-government authorities and finance professionals who don't understand accounting (even though they have had over a century and a half to learn), the profession of accounting has been an enthusiastic participant in their loss of jurisdiction over financial reporting. In the vernacular of attribution theory, Professor Baker is committing the fundamental attribution error, i.e., when things go bad, it is attributable not to me, but to thee. History suggest otherwise.

The current framework within which financial reporting policy is made is a framework constructed exclusively by accountants. Williams and Ravenscroft (2011) provide a history of this process, which was essentially the rise of decision usefulness as the rationale for financial reporting policy. Statement of Financial Accounting Concepts No. 1 (FASB, 1978), the "objectives" statement is essentially the product of a committee headed by Robert Trueblood, a professional accountant. It was largely based on an earlier document produced by a committee of the American Accounting Association, the ASOBAT Committee

(AAA, 1966). It was academic and professional accountants alone who proclaimed that the purpose of financial reporting is to provide information useful for predicting future economic events, most notably cash flows. That accountants will never be able to do this seems not to have dulled the enthusiasm accountants have for branding themselves as providers of useful information. Ijiri (1975) remarked on the bazaar nature of this radical change in the discourse of accounting from one that historically was rooted in accountability to one now based on facilitating the workings of efficient capital markets. As Ravenscroft and Williams (2009) argue this radical change in how accountants described themselves was not the result of a Kuhnian paradigm shift but the result of a political movement (the neoliberal revolution) characterized by a preference for a more libertarian society of small government, unregulated markets, and personal responsibility.

The neoliberal revolution has led to the extensive financialization of the Western economies, no more so than in the U.S. (Phillips, 2002). The accounting profession financialized as well. Instead of *Management Accounting* the missal of the Institute of Management Accountants became *Strategic Finance* – cost/managerial accounting was re-branded as internal financial reporting. Auditing, with all of its ominous overtones became “assurance.” Research in the U.S. academy is overwhelmingly empirical financial research whose connection to accounting practice is merely that it is published in journals with accounting in their titles. The few scholars that warned of the dangers of this re-branding (e.g., Ijiri) have been relegated to the dustbin. The social consequences of this revolution in which the profession so willingly participated have been startling, no more so than in the U.S.

The United States Congressional Budget Office recently published a report on the changes in the distribution of household income in the U.S. from 1979 and 2007. During this period of time the income growth of the U.S. middle class (those in the middle three quintiles) totaled 37% (CBO, 2011, p. 3). However, for the top one percent of the households’ income growth for this same period was 276% (ibid). At no time in American history has there been such a dramatic and radical shift in income from the many to the few. The U.S. is now a country with the most skewed distribution of income and wealth of any O.E.C.D country. There have been many explanations offered by conventional economists: globalization, job complexity outstripping educational attainment, etc. However, none of these explanations are adequate; they don’t account for the dramatic nature of the shifts.

Hacker and Pierson (2010) two political scientists have done extensive analysis of the income and wealth distribution data and have concluded that political changes have more to do with the drastic changes in income distribution

than the standard explanations provided by conventional economists. As they noted:

Inequality is dramatically higher in the United States not because of greater skill gaps or greater returns to education, but because within-group inequality is greater than it is in other rich nations. Indeed, there is more inequality among workers with the *same* level of skills (measured by age, education, and literacy) in the United States than there is among *all workers* in some of the more equal rich nations (2010, p. 37).

And the individuals who have benefited most from this radical redistribution have been executives and financial professionals – 60.2% of the richest 0.1% of Americans are in these two categories (ibid, p. 46).

What is discouraging to a person of conscience that is closely allied with the accounting profession is that during the 32 years that this radical redistribution of income and wealth in the world's oldest constitutional democracy has been occurring, a perusal of the accounting literature would reveal the professions seeming unawareness that it was even happening. The primary role that financial markets have played over the past 30+ years has not been to lead to more efficient allocation of resources to the benefit of everyone in the society, but the dramatic redistribution of income and wealth from the many to the few. The profession has enthusiastically abetted this result. It has stood silently by while this occurred, merely proclaiming that it was socially useful because it was providing information useful for assessing the timing, amount, and uncertainty of cash flows (as well as concocting complicated tax avoidance strategies that benefit only the ones with enough wealth to utilize them). The so-called financial reporting revolution (Beaver, 1981) has made the vast majority of Americans far worse off economically, which raises important ethical questions about "just societies" and whether the accounting profession has any obligation to concern itself such things (Murphy and Nagel, 2002). If the medical profession was mute about a forthcoming epidemic merely to increase its income from treating the increasing number of sick people most would regard that as a serious moral failing on the part of the profession. Yet the so-called accounting profession, which is the public's eyes inside very powerful corporations (which, after all, are given their right to exist from the public), has fastidiously avoided seeing anything out of the ordinary, anything that isn't business as usual. The title of this journal juxtaposes accounting and law, which is appropriate. Accounting is part of a society's justice system. It defines obligation and regulates; it doesn't abet. This is something accounting has done since it began (Schmatz-Besserat, 1992).

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