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The Politics of Accounting Standards: A Comment on Ramanna’s “Unreliable Accounts: How Regulators Fabricate Conceptual Narratives to Diffuse Criticism”

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Abstract: Karthik Ramanna recounts how the Financial Accounting Standards Board (FASB) dropped “reliability” as a fundamental property of accounting in 2010. He offers two possible explanations for this change: (1) The FASB removed reliability to clarify its conceptual framework, and (2) It sought to reconcile its framework with the growing use of fair-value accounting. Ramanna does not give total victory to one explanation over another, nor does he assign purely public- or private-interest motives to the actors in the story. Yet this very ambiguity tells us a lot about the distinctive politics of accounting and other technical realms of regulation, and exposes some of the shortcomings of more standard interest-group models in political science.

Keywords: accounting standards, FASB, politics, regulation, regulatory capture

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References

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Unreliable Accounts

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1 Introduction

Karthik Ramanna recounts the tale of how the Financial Accounting Standards Board (FASB) dropped “reliability” as one of two fundamental properties of accounting (along with “relevance”) in 2010, and replaced it with the principle of faithful representation. He juxtaposes two possible explanations for this change. First, the FASB’s official rationale maintains that it removed reliability to clarify its conceptual framework because the term had come to be misunderstood in practice to imply measurement precision. Second, some insiders suggest that the FASB actually made the change to reconcile its framework with the growing use of fair-value accounting.

In this comment, I make two basic points. (1) Ramanna takes a somewhat equivocal position on the debate he sets up. He does not characterize the accounting standard-setting process as either wholesomely rational or wantonly political. He does not depict the decision-makers as strictly independent or utterly captured. (2) Yet this very ambiguity reflects the nuances of the subject matter, and suggests some ways in which we might refine our models of the politics of regulation in technical domains.

The following sections will address these two points one after the other.

2 Rational Adaptation or Post Hoc Justification?

Ramanna acknowledges at the outset that he finds evidence for both of the explanations noted above: rational adaptation and post hoc justification. Specifically, the archival record and interviews demonstrate that some individuals involved in the process actively promulgated the first rationale, while others favored the second. Ultimately, however, Ramanna leans toward the latter position. He does not go so far as to charge that the first is false, but he claims that it is “incomplete at best.” He concludes that the FASB could reasonably be viewed as trying to legitimize its support for fair-value accounting with its rationale for the change.

Yet if the FASB was adapting its conceptual framework to the reality of widespread adoption of fair-value accounting, then what’s so wrong with that? Ramanna raises this normative question without fully resolving it. With a more charitable interpretation of the FASB’s decision, one might argue that the board had a responsibility to update its framework to function properly in this new environment. And having made that decision, it was obligated to offer a public statement of justification for the move. With a more cynical interpretation, one might charge that the strongest advocates for the change were at least partially captured by financial interests that stood to benefit from the expansion of fair-value accounting. And those advocates then expended considerable effort to develop a rationale for the change after the fact precisely to defend themselves from accusations of capture.

The reader can discern that Ramanna leans toward the more cynical view from the language of his core construct – “conceptual veiling” – which implies that some deception was involved. And he is perhaps most explicit with his normative stance at the very conclusion of the article:

The changes to the conceptual framework have provided conceptual cover to regulators and special interests advancing a fair-value agenda; it has deflected the appearance of capture over fair-value accounting. This conclusion is especially troublesome given the role of fair-value accounting in prior accounting scandals such as Enron and financial crises such as those of 1929 and 2008.

That is, he is especially concerned by this “veiling” because the proliferation of fair-value accounting practices can have detrimental real-world consequences.

3 The Politics of Regulation in Technical Domains

Nonetheless, I do not fault Ramanna for failing to give total victory to one explanation over another, or to assign purely public- or private-interest motives to the

actors in his story. For this very ambiguity tells us a lot about the distinctive politics of accounting and other technical realms of regulation. By combining Ramanna's past work with the archival and interview evidence presented in this article, we can expose some of the shortcomings of more standard interest-group models in political science, whereby those interest groups with the greatest financial and organizational resources lobby politicians, who in turn shape legislation and exercise oversight over executive branch agencies. And we can extract some key insights into these distinctive features, as outlined below.

3.1 “Thin” Political Markets

In previous work, Ramanna depicts a core feature of the politics of accounting standards as the “thinness” of the political markets, meaning that the decision-making arena is dominated by experts with ties to the financial sector, with little involvement by the broader public. This favors regulatory capture by the best-informed interest groups (Ramanna, 2015). And in this article, he stresses that regulators have much more contact with experts than with ordinary citizens, and those experts may have an agenda. Likewise, Pepper Culpepper describes the politics of technical fields such as corporate governance as “quiet politics,” which favors industry unless a particular issue becomes more broadly politically salient (Culpepper, 2011).

3.2 Complex Interest Cleavages

The politics of accounting standards may be “thin,” but that does not mean that the interest cleavages are simple. In this article and in his earlier work, Ramanna demonstrates the subtle differences in outlook among accounting professionals, investment bankers, investment managers, accounting scholars, and regulatory officials – plus the variations within each of these groups.¹

3.3 Cultural Capture

Ramanna's article also suggests that regulatory capture may take a “softer” form in a technical realm like accounting. That is, industry may not deploy financial and

¹ Gourevitch and Shinn (2005) provide one model of interest groups and coalitions in corporate governance debates, and Vogel (2018, 15–18) outlines some of the interest cleavages in market governance issues more broadly.

organizational resources to lobby decision makers directly so much as to enjoy a sort of “cultural” capture whereby industry executives and regulatory officials develop shared understandings via common professional training, social networks, and a revolving door between government and industry (Kwak, 2014).

3.4 The Politics of Persuasion

In reality, the decision makers are neither fully autonomous actors single-mindedly pursuing the public interest, nor simply agents of industry. The deliberations over accounting standards are not only clashes of interests, but also contests of ideas. There are real substantive differences in definitions of the public interest, and the argumentation over principles weighs heavily on regulatory outcomes in the field.² And as Ramanna notes, this sometimes takes the form of games in which actors deploy rhetoric to favor their own position.

3.5 Private Sector Governance

Accounting is also distinctive because it relies more heavily on private governance than many areas of regulation (Bütte & Mattli, 2011). The FASB is a private non-profit organization embedded in a broader structure of public authority over financial regulation and corporate law. This can make the FASB even more vulnerable to soft industry capture than a government regulatory agency because so many of its board members and its staff come from accounting, financial, and industrial firms, and share common professional norms and personal networks.

3.6 Bureaucratic Politics

The politics of accounting regulation thus differs from other issue-areas dominated by public regulatory authorities, yet models of bureaucratic politics are nonetheless useful in understanding the core dynamics. That is, the political dynamics are not so much that of interaction between political leaders and regulatory officials, but rather among the various bureaucrats themselves (Allison, 1969). These officials may adhere to particular regulatory doctrines given their training – in law, economics, or accounting, for example – and some deliberations may center on the differences among these worldviews. Moreover, officials within these regulatory

² Lindblom (1977) identifies persuasion as one of three core mechanisms of social control (along with authority and exchange) in his classic work on politics and markets.

bodies, whether public or private, may be less concerned about direct lobbying pressures and more concerned about the potential fallout if something goes wrong – a phenomenon Ramanna refers to as the “cover-your-ass” (CYA) syndrome.

In sum, we need more sophisticated models of the politics of market governance, not only accounting. For market governance is growing as a core function of government, and as a major factor in public welfare, from growth and equity to climate change and public health.³

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³ Some of the most rapidly growing sectors of the economy – such as information technology and finance – are those most powerfully shaped market governance. And some of the items on the market governance agenda – such as antitrust policy and financial regulation – are among the most consequential economic policies today: Vogel (2018), 147–50.