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Since the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, the US has recognized the importance of regulating public securities markets. A central feature of regulatory activity has been to provide standards regarding the quality of information provided by management to investors. This has taken on added importance since the scandals of the early 2000s (with the passage of the Sarbanes-Oxley Act of 2002). Later, the near-meltdown of the world’s financial system in 2008-9 made the systemic risk of a repeat of this situation a major worry of the governments of many countries including the US (e.g., the Dodd-Frank Act of 2010). These crises resulted in the creation of several high-level international organizations to monitor the setting of standards governing the preparation and disclosure of financial information, based on a belief that reliable information is essential for the proper functioning of securities markets. In one way or another, they address financial reporting, auditing, and ethics standards for public companies and auditors around the world. (The US is somewhat separate, since it sets these standards on its own; however, relevant American standard setters and regulators are active participants in these processes.)

In addition to providing guidance about best practice in financial reporting and auditing, one of the primary purposes of regulation (and financial reporting, auditing, and ethical standards) is to constrain self-interested behavior. Since corporate financial reporting is governed by a plethora of standards, several questions arise: Who sets those standards, and how and why they do it? Of special concern, what is the role of self-interest of various interested parties (i.e., managers, auditors, and standard setters) at this “meta-level”? Karthik Ramanna’s Political Standards addresses these critical and timely issues.

Ramanna focuses on one aspect of this general picture, the setting of financial reporting standards. At the same time, he has a bigger project in mind, which is that the setting of accounting standards is an instance of a more general societal problem: that many standards or regulations are set with the participation of parties who have an active special interest in their content, while the interests of the public
are not adequately represented. The result is that standards are set that are not in the “general interest” of society. The problem, he argues, is that regulations are being set in a “thin political market,” which he defines as “a political process of designing essential technical rules of the game in areas where substantive expertise lies with vested interests and where the general interest is usually not involved” (1). The thin market for financial reporting standards is problematic for Ramanna because the result reduces the economic efficiency of the securities markets and is a violation of the general interest in the capitalist system. Thus, he argues, the moral standing of competitive behavior in securities markets is compromised.

In arguing for this view, Ramanna provides an extended examination of several aspects of financial reporting standards. After an introductory first chapter that lays out the general picture, chapter 2 presents a basic and quite readable account of two conceptual frameworks underlying financial reporting. Building on this, Ramanna addresses in the five following chapters a number of issues relating to financial reporting standard setting. Chapter 3 examines the actions of management by focusing on an important and controversial issue, accounting for mergers and acquisitions. Chapter 4 is an examination of the lobbying behavior of auditors, in relation to setting standards employing the fair value approach to accounting. Chapter 5 looks at the behavior of standard setters—specifically, members of the Financial Accounting Standards Board (FASB)—who are the subjects of the lobbying behavior and interference delineated in chapters 3 and 4. An important aspect of this is that the FASB is structured to be independent of both of these interest groups and to act in the public interest. Ramanna argues that over time, the FASB has increasingly consisted of individuals associated with the financial services industry, with the result that standards have increasingly been based on the use of fair values (which he claims is in the interest of the financial services industry, as well as the audit industry, and of certain academics).

Chapter 6 presents two case studies of the standard-setting process in the context of two developing economies (China and India) relating to the development of international financial reporting standards. Chapter 7 examines the establishment of a separate standard-setting body for companies whose securities are not publicly traded: the Private Company Council.

Readers of this journal are likely to be more interested in the latter part of the book, which builds on the foregoing chapters. Chapter 8 argues that the problems identified in earlier chapters are symptoms of three elements of the standard-setting process. First, the process is dominated by a small number of individuals (mostly corporate management, bankers, and auditors) who have both the rare expertise to deal with the complexity inherent in this domain and strong individual interests in the outcome. In addition, there is little or no input or opposition by or on behalf of investors or the general public. Second, the result of this structure, according to Ramanna, is a “thin political market,” whereby a scarce resource (financial reporting standards) is biased towards the interests of the parties identified above. The difficulty in this situation, he argues, is that the standards set are not in the general interest because they interfere with the efficient functioning of public securities markets. Third, in the regulatory capture of standard setting no specific identifiable
group of interested parties dominates on every issue because the expert individuals participate in the process only when their own interests are sufficiently affected.

Given the difficulties Ramanna identifies, the problem is how financial reporting standards should be set. He recognizes that leaving accounting standards to market forces is infeasible because they are public goods, with the familiar difficulties of obtaining the optimal outcomes. Thus, some regulatory structure is required. Ramanna argues that the problems identified in chapter 8 are found in areas other than financial reporting, where the required expertise is possessed by a small number of individuals who have a strong individual interest in the outcome.

Chapter 9 presents a relatively brief and preliminary description of Ramanna’s approach to addressing the problems identified in chapter 8. The basic argument is based on Milton Friedman’s claim that the social responsibility of business is to maximize profits, subject to not violating laws. Ramanna agrees with this as a moral claim underlying the morality of capitalism, based on the power of the invisible hand to produce economic wealth, and on the ability of markets to foster freedom of individual choice. But, he argues, this holds only for competitive markets, and the “thin market” for accounting standards is not competitive for reasons mentioned above.

Because altering the institutional structure of standard setting has been tried before with lackluster results, Ramanna argues that some other approach must be introduced: the adoption by interested parties in the process (corporate managers, bankers, and auditors) of an ethical point of view. Thus, while they are free to act in a self-interested manner in the basic securities market, where prices control behavior, these same people are expected to take into account the general interest when they lobby for financial reporting standards. According to this argument, doing so would produce a regulatory outcome that is in the general interest.

Ramanna argues that this is an extension of Friedman’s views on the social responsibility of business, but it is hard to see how this is so. If maximizing profits is their responsibility, then it is not clear why they should cease doing so in a regulatory domain that stands to reduce profits. (This analysis also ignores the well-established fact that managers tend to act in their own interest, rather than to maximize the profits of the corporations they manage.) His answer is that social norms should be shifted so that managers, bankers, and auditors adopt this non-egoistic point of view. The idea is attractive in the sense that, if successful, norms might motivate interested experts by providing incentives to act in the general interest. But it does not appear to be consistent with his fundamental view of rationality (that individuals are self-interested) and do not (or should not be required to) take account of the interests of others. Why would it be rational for such people to adopt a point of view that encompasses the interests of others?

This book is valuable in bringing together extensive and detailed evidence in a number of important areas of financial reporting, addressing some of the ways in which corporate management may engage in strategic behavior that benefits them by influencing the agenda of the major accounting standard setter in the United States. At the same time, while Ramanna introduces his own interpretation and research into the mix, little here (in chapters 3 through 8) is really new to either scholars of financial reporting standards or standard setters themselves.
Focusing on chapter 9, the fundamental difficulty is that this sudden shift to a moral point of view comes from nowhere. It is based purely on economic, market-oriented concepts, but there is no discussion in the book of any ethical concepts that are not rooted in financial economics, and that focus on the self-interested behavior of individuals in competitive markets à la Friedman. So, to the extent that readers have difficulty with Friedman’s position or the arguments in support of it, those difficulties are compounded by Ramanna’s extension of it to the noncompetitive market for accounting standards (and other domains that are characterized as “thin political markets”). In this sense, beyond his appeal to Friedman, the author’s views about how financial reporting standards should be set lack a theoretical foundation.

There are other issues that are not presented or examined, and their omission may be problematic to readers of this journal. I will mention three here.

First, although the emphasis in chapter 9 is on the relevance of the interests of nonparticipants in the standard setting process, such as investors, labor unions, and others, there is no mention of stakeholder theory or related concepts that focus on the ethical limitations of self-interested behavior.

Second, the emphasis on the concept of a political market depends on a definition of markets that is questionable in its utility. The standard definition of “market” focuses on “an institution through which multiple buyers or multiple sellers recurrently exchange a substantial number of similar commodities of a particular type” (Hodgson 2018). Ramanna’s concept of a market is, he recognizes, an analogy to such markets, relating to a general level of human interaction. One of the results of this market-oriented approach is to downplay the importance of power in this regulatory setting, where power is associated with the threat and use of sanctions on others in order to effect a preferred outcome (Bowles and Gintis 2018). Chapter 3 discusses at some length the interference of members of the US Congress into the standard-setting process, including explicit threats to the FASB, but does not discuss power per se.

Third, it is understandable that Ramanna focuses the book on one aspect of the informational aspects of financial reporting, the development of financial reporting standards. But this limitation comes at a cost, for the exclusion of the institution of auditing neglects an essential part of the overall picture. Securities market regulators recognize that corporate managers (and auditors) may manipulate standards in their self-interest, and thus may manipulate the content of financial reports and audit reports. For this reason, as mentioned above, regulators have been increasingly concerned with the quality of audits of corporate reports. Because of the centrality of auditing, and the fact that the development of both audit and ethics standards fits the definition of a thin political market, Ramanna’s analysis misses a critical feature of financial reporting. Counter to his norm-oriented approach in chapter 9, regulators have taken an aggressive approach to the quality of audits (which are supposed to provide assurance about the quality of the information provided by corporations). The underlying lack of trust in auditing, in view of the self-interested incentives and behavior, has translated into government-sourced regulation in the US and into increasingly aggressive oversight at the international level, with a focus on professional skepticism of auditors and on their independence from their clients.
This has resulted in a significant move away from the self-regulation of (and the opportunity for self-interested behavior within) the auditing profession. The problem being addressed is a lack of trust that auditors—both in their practice and in the setting of audit and ethics standards—will act in the general interest. Thus, there is a chain of fairly aggressive organizations that oversee the processes of developing audit and ethics standards and assuring that these thin markets serve the general interest. In this context of distrust by regulators and skepticism about the ability of interested parties to act in the general interest, it appears unlikely that securities market regulators will adopt Ramanna’s approach any time soon.

REFERENCES
