The New York Times

Room for Debate: A Running Commentary on the News

« Room for Debate Home

« Back to Discussion

What's Wrong With Accountants?

Ernst & Young may soon be sued for its role as auditor of Lehman Brothers. What kind of oversight do accounting firms need?

Problems With Accounting Standards

Updated December 21, 2010, 07:28 AM

William A. Niskanen *is chairman emeritus of the Cato Institute, the contributing editor of "After Enron: Lessons for Public Policy," a former member and acting chairman of President Reagan's Council of Economic Advisers, and a former chief economist of the Ford Motor Company.*

Current financial accounting is often not a very good guide for either corporate managers or investors. The primary policy issue now is whether accounting standards should continue to be set by the Financial Accounting Standards Board (FASB) and approved by the Securities and Exchange Commission (SEC). I would suggest not, for the following reasons:

There is no obvious reason why any one set of accounting standards is best for all firms in all industries or stock exchanges. There is no evidence that the accounting standards board, the S.E.C., and Congress have an advantage over other institutions in setting accounting standards.

> U.S. accounting standards have become unusually complex and vulnerable to subjective interpretation.

The FASB has been slow to develop standards for new types of financial transactions and conditions, has allowed the U.S. accounting standards to become unusually complex and vulnerable to subjective interpretation, and has been vulnerable to several controversial accounting doctrines.

The S.E.C. has no particular advantage in reviewing and approving the changes recommended by the FASB, except to interpret the balance of current political demands. In response to a Congressional order to study the comparative value of rules-based and principles-based accounting, for example, the S.E.C. straddled the issue. As an alternative, the S.E.C. staff endorsed an objectives-based approach that would set broad goals backed by enough detail to produce meaningful, informative financial statements — but they did not define what this concept would involve. In the meantime, Congress has neither the professional expertise nor the correct incentives to endorse generally accepted accounting principles, and is more inclined to defend or create some special interest.

What to do? At a minimum, the S.E.C. should approve the proposal by the American Institute of Certified Public Accountants to limit fair valuation of nontraded securities to separate registered investment companies, no owner of which may own more than 20 percent of its financial interests. More important, the S.E.C. should permit corporations with publicly traded stock to have the option of basing their accounting statements on either the U.S. or international accounting standards.

One lesson learned from the financial crisis is that each stock exchange should be allowed to set the accounting standards for corporations listed on that exchange.

Another accounting lesson highlighted by the failure of several large corporations is that the best possible financial accounting should be complemented by reporting the primary *nonfinancial* indicators of the earning potential of a firm. Such indicators are typically industry specific and may best be developed by the relevant trade association.

The market value of most contemporary firms is a multiple of the book value, and many types of changes can affect the market value of a firm, for better or for worse, that are not reported on the balance sheet. The major challenge to accountants now may be to develop the types of nonfinancial indicators of earnings potential that are most useful to both managers and investors.

Topics: Andrew Cuomo, Business, Ernst & Young, Law, Lehman Brothers