What Distinguishes Accounting Harassment from Sexual One? Caveat Emptor Might Be Better Than You Think

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Abstract

Optimality in accounting standards is elusive, and a tireless quest for it through empirical research seems rather Sisyphean. Then, why don't we let market participants decide as we do in most consumer goods? On the other hand, even card-carrying free market advocates seem to have a hunch that some labor standards such as prohibition of sexual harassment and protection of workers engaged in dangerous jobs are on the right track although it means usually sacrosanct voluntary agreements between adults are overruled.

In this paper, I try to make this hunch a reasoned argument based on Kaushik Basu's justification on prohibition of sexual harassment which consists of both positive and normative parts. In the positive economic part of the argument, the insufficiency of marginal analysis is presented. Freedom of contract or no mandatory requirement on accounting practices does not necessarily Pareto improve the whole economy because the aggregate behavior of price-takers (investors) changes the demand structure. We need more than the economic argument to justify imposing standards, however. The normative part closes the argument for some labor standards invoking the inviolable principle. Although it is not difficult to admit to the reasonableness of the principle in case of these labor standards, it is rather doubtful to apply this moral part to accounting standards considering the nature and role of financial markets, to which accounting standards are expected to give service.

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Mr. Hunt, this isn't mission difficult, it's mission impossible. "Difficult" should be a walk in the park for you.

Mission Commander Swanbeck

My naïve 16-year-old mouth might have blurted out…"It's my utility function, and I don't have to maximize it if I don't want to." But, as a grown economist, I'd never say such things.

Alan Blinder

1. Introduction

In an introductory economics course, we were taught and teach that regulations sanctioned by the government usually do more harm than good. Skeptical attitudes toward regulations are not confined to class rooms. Free market economy has become a more accepted way of life among ordinary citizens all over the world ever than before. In spite of this general trend, accounting standards are now expected to function as regulatory instruments to impose some deliberately constructed rules rather than codifications of spontaneously emerged practices, which once were.

It is argued that more regulations on accounting practices are not inconsistent with the market-oriented trend. Free market economy functions properly only if its infrastructure is well established and maintained. Accounting is naturally considered a core of the infrastructure, to which usual economic logic and freedom of contract are not directly applicable.

Are they? The reasons routinely offered why free competition is inappropriate are externality and information asymmetry. However, if citing the existence of these two aspects is enough to justify government-sanctioned regulations, it is virtually impossible to find any unjustifiable regulation. Moreover, it is difficult to reconcile these justifications with the fact that there is a minimal, if any, regulation on marriage, in which externality and information

asymmetry are huge. Or should we establish the marriage standards board as soon as possible?

On the other hand, even card-carrying free market advocates seem to have a hunch that some labor standards such as prohibition of sexual harassment and protection of workers engaged in dangerous jobs are on the right track although it means usually sacrosanct voluntary agreements between adults are overruled.

In this paper, I try to make this hunch a reasoned argument based on Kaushik Basu's justification on prohibition of sexual harassment which consists of both positive and normative parts (Basu 2002 and 2003). In the positive economic part of the argument, the insufficiency of marginal analysis is presented. Freedom of contract or no mandatory requirement on accounting practices does not necessarily Pareto improve the whole economy because the aggregate behavior of price-takers (investors) changes the demand structure. We need more than the economic argument to justify imposing standards, however. The normative part closes the argument for some labor standards invoking the inviolable principle. Although it is not difficult to admit to the reasonableness of the principle in case of these labor standards, it is rather doubtful to apply this moral part to accounting standards considering the nature and role of financial markets, to which accounting standards are expected to give service.

Before delving into the main argument in Section 4, I first consider conceptual and empirical difficulties in search of *the* best accounting standards in Sections 2 and 3 respectively.

As alert readers soon notice, I will try to keep the endogenous nature of accounting in mind aspiring to meet a challenge posed by Demski (2004). Throughout the paper, I only consider the welfare of investors not because they should be given primacy over other related parties but because I want to show that even this "simple" objective is difficult, if not impossible, to attain.

2. Optimal Standards: Is Income Closer to Intelligence or Height?

Enron and other scandals have made the general public as well politicians pay critical attention to the substance and enforcement of the current accounting standards. Dishonest and greedy managers have taken advantage of the accounting profession's negligent practices to their own unjustified self interest, or so told. Perhaps due to the obstruction of the powerful vested interests around accounting numbers, the optimal standards from investors' point of view have been kept from being established for so long a time.

A typical argument goes as follows. It is a sine qua non to make accounting numbers objective and verifiable for investors to judge corporate performance adequately. Standard setters must strive for the optimal standards which help investors make reasoned judgment having managers and auditors comply as rigorously as possible. Although the argument seems unobjectionable, what accounting tries to measure is not so simple as generally asserted in the popular press. Objectivity and verifiability are goals commendable to quest for, but subjective and unverifiable elements are also needed to construct such accounting numbers as income. This subjective nature of accounting is unavoidable because we have to know the future income to decide how much the current income is. For example, the present value of future expenditures such as pension payment is needed to determine the current income, but the number is inherently subjective. Moreover, a recent trend for more subjective elements in accounting numbers has been supported by investors themselves.

For better or worse, income, the bottom line figure of accounting, is much closer to intelligence than height though public discourse implicitly assumes otherwise. The height of a person can be objectively measured and different measurement scales have one to one correspondence (e.g., one inch equals 2.54 centimeters). His current height does not depend on what he and others believe and would do in the future. On the other hand, *the* definition of intelligence is impossible rather than difficult to reach. Above all, what others as well as he believe is crucial. What I believe signifies intelligence is not unintelligible to you and him, but our opinions surely differ. It would be pointless to define what the right measure of intelligence, is though our opinions might not be extremely diverse. Even if our opinions miraculously converge to a consensus, the measure of intelligence depends on that consensus, which may be different from time to time.

The height of a person at a particular time has only one true value and we can make measurement errors sufficiently small for any practical use. If the measured heights of Joel and Shyam are identical, we are entitled to expect Joel is as tall as Shyam. However, if the reported income figures of GM and GE are identical, do we claim they are equally profitable? The profitability of a corporation is not measurable with one-dimensional scale.

Demski (1973) formalizes the argument above and shows us the famous impossibility theorem. His theorem is all the more powerful because it holds even if he abstracts away not only cost consideration but also aggregation, the latter of which tends to fall into a conversation stopper due to the Arrow impossibility theorem when we argue about the economy's welfare. In a sense, a representative agent framework is assumed.

The key concept which measures informativeness is *fineness*. Suppose we have two

sets of accounting standards x and y. Then, x is finer than y if every signal from x is fully contained in y but not vice versa. In other words, x partitions the set of states more finely than y. Suppose there are five states, a, b, c, d and e. x give us signal s_{x1} if a or b occurs, signal s_{x2} if c or d occurs, and signal s_{x3} if e occurs, while y give us signal s_{y1} if a or b occurs, and signal s_{y2} if c, d or e occurs. It is clear that if we know a signal from x, we can construct the corresponding signal from y, but not vice versa. However, this ordering based on fineness is not complete. If another set of standards z give us signal s_{z1} if a occurs, and signal s_{z2} if b, c, d or e occurs, z is neither finer than x or y, and neither x or y is finer than z.[1] Thus, we can order neither (x, z) nor (y, z), while we can (x, y).

Then, it can be shown that the rational expected utility ($E(U|\cdot)$) maximizing investor prefers x to y if and only if x is finer than y.[2] With this result, we can obtain the impossibility theorem that no measure of information quality $I(\cdot)$ independent of the investor's preference and belief exists such that $I(x) \geq I(y)$ if and only if $E(U|x) \geq E(U|y)$. The theorem says we cannot decide which is better without knowing what the investor has in mind. Of course a set of standards partitioning the states completely is always preferred to any other set. In the example above, if we have a set of standard that gives us five signals corresponding to the five states separately, this set is (one of) the optimal. However, if we had such a set of standards, we would know every state in the future as well as the past, which would render investment under uncertainty non-existent.

Though abstracted away in the formal model, it may be argued that reduction of information production cost should enable managers to provide investors with more information that can partition states more finely through accounting numbers not necessarily limited to income. But investors' time is now more precious than ever. As for information, because deliberation cost[3] is the most crucial, more information is not necessarily useful for investors if we take cost into consideration.

Responding to critical comments of Chambers (1976), who maintains the "height" view of accounting, Demski (1976, 654) points out that the demand for information is derived and endogenous in the sense that investors want information to enhance their welfare through more reasoned judgment based on it. Income is not out there as height is, but exists in your minds. Income is likely to be more elusive than intelligence because the former depends on utility, whose connection with our biology is remote in affluent society, while the latter is

[1] Also z is neither as fine as x or y.
[2] To be more precise, $E(U|x) \geq E(U|y)$ if only if x is as fine as y.
[3] Moreover, Conlisk (1996) points out that the usual maximization framework does not work for deliberation cost.

more directly linked to our evolutionary history.

Notice this impossibility theorem does not claim we cannot reach Nirvana in accounting standards, but rather remind us that we cannot find them unless investors' preferences and beliefs are given. If we cannot decide which accounting standards are better without knowing their preferences and beliefs, why should we hesitate to look into market data which hopefully reveal them? Next, I examines a data-based search for optimal standards.

3. Stock Markets Based Research: Mission Difficult or Mission Impossible?

Since the purely conceptual approach seemed to reach an impasse culminating in the aforementioned impossibility theorem of Demski (1973), a research program linking accounting information to stock prices has flourished. An empirical approach, widely known as value relevance studies, with the emerging efficient markets hypothesis, seems promising once investor primacy is accepted. What else could be more appropriate to find the optimal standards for investors than stock prices in efficient markets?

A typical research design runs as follows. A statistical relation metric R (the higher, the better) between a stock price p and certain accounting related numbers (e.g., earnings, ROE) A is proposed. Researchers not only pick up accounting numbers from published records but construct alternative numbers which would obtain if other accounting standards were used.[4] Let $A(S_{cu})$ denote numbers under the current standards (reported one) and $A(S_{al})$ those under the alternative standards. Finally, the values of the relation metric $R(p(S_{cu}), \mathrm{A}(S_{cu}))$ and $R(p(S_{cu}), A(S_{al}))$ are compared. The expression $p(S_{cu})$ rather than p makes it explicit that a stock price is under the current standards.

The logic behind these value relevance studies is not innocuous, however, as Ronen (2001) points out. First, a high statistical correlation between accounting numbers and a stock price does not imply those numbers are useful. A high correlation means a stock price does not reflect non-accounting information orthogonal to accounting one very much. If stock markets are expected to be efficient, is it bliss? It might be argued that if we interpreted this high correlation between a stock price and accounting numbers as a consequence of non-accounting information highly correlated with accounting one, this high correlation would still imply the usefulness of accounting information. But this line of reasoning is

[4] The strategy mentioned here is essentially similar to a widely practiced research strategy whether several other accounting numbers enhance the value of the relation metric keeping the reported numbers themselves intact.

self-destructive. If stock markets are informationally efficient, why do we need any other metric than a stock price, which is perfectly correlated with, what else, a stock price?

Therefore, in order to know something about the usefulness of accounting numbers in relation to a stock price, we have to consider what would happen if alternative standards were implemented. The comparison between $R(p(S_{cu}), A(S_{cu}))$ and $R(p(S_{cu}), A(S_{al}))$ could go nowhere. The real starting point must be the comparison between what we get under the current standards and what we would get under the alternative standards, that is, $p(S_{cu})$ and $p(S_{al})$. An inherent difficulty is the fact that a price under the alternative standards $p(S_{al})$ is not observable.

To tackle this obstacle in empirical studies, Sunder (1989) poses an ingenious framework. In his model, standard setters try to utilize stock prices for better standards taking the maximization of investors' welfare as the sole objective. These standard setters induce a price change in markets and make policy based on it. More concretely, first, new standards are announced. Second, an incremental price reaction in stock markets p is observed. Third, accounting standards are actually modified based on p. The response function of the standard setters $M(p)$ is defined as the probability of reversing the original policies if the observed price change is p. The standard setters do not know the real effects caused by the change of future cashflow. Otherwise, it would be pointless to try to utilize a response in markets.

An equilibrium condition under the efficient market hypothesis is a blow to value relevance studies, however. In equilibrium, $p \cdot (1 - M(p)) = 0$, that is, either zero probability of policy reversal $M(p) = 0$, or no equilibrium price change $p = 0$ (or both) must hold.

Sunder (1989, 458) summarizes his results in a few sentence that we are familiar with in other contexts. "If we assume that a policy making body, such as the FASB, would systematically (note, not deterministically) use the results *of* stock market event studies to make policy, it is not reasonable to assume that the stock market will remain oblivious to such use for long. When we consider the effect of such policy use *of* stock price on stock prices, the usefulness of market studies for making policy evaporates."

Endogeneity again. Indeed this is a straightforward application of the famous Lucas critique (Lucas 1976) to accounting standard setting. The message is that it is not difficult to maximize investors' wealth but impossible to do so through standard setting based on *observed* price changes if markets are efficient, that is, stationary and unbiased.[5] Still, Sunder (1989, 459) asserts that "If stock price consequences of specific policy proposals can be

[5] See Bossaerts (2002) for what is actually assumed in empirical studies based on the efficient market hypothesis.

estimated with a reasonable degree of accuracy by some indirect means, such estimates may form a useful input into the policy making process." As Ronen (2001) points out, what we have to do may be the construction of unobserved prices which we would observe if another policy were taken. In order to accomplish this seemingly Sisyphean task (or perpetual career making device), we should construct models taking only deep parameters invariant.[6]

However, if we take the idea of the rational expectations hypothesis to its logical conclusion, any policy, as we understand it, cannot exist (Bicchieri 1987).[7] In stationary and unbiased markets, every event is recurrent and investors have subjective beliefs coincident with objective ones about the probability distribution of policy changes. There is a risk but no Knightian uncertainty. Therefore, no action of policy makers is discretionary because investors can correctly predict on average what to be done by policy makers. Under the rational expectations hypothesis, markets set a price that reflects the future possibilities of standards changes conditonal on observed as well as unobserved prices or whatever. Even rule-based policies, which Sunder (1989) as well as Lucas (1976) seem to have some hope for, are not well-defined.

Yes, humans are not that rational and our future is full of surprise. I concede that there may be truly surprising events, which outwit hyper-rational investors. However, because accounting policy changes are routine and recurrent, rarely, if ever, deviating much from the status quo, it is totally unconvincing to assume that investors are surprised at any actual policy change as well as its announcement.

As Lucas (1976) emphasizes, though econometric analysis is useless for policy evaluation, it can be very useful for short-term forecasting. In the latter aspect, value relevance studies may continue to be relevant for fund managers though falling short of their original aspiration. On the other hand, if we discard the equilibrium approach based on the rational expectations hypothesis but want to extract policy implications from empirical studies, we have to construct some models based on explicit (non-rational, bounded rational or irrational) expectations formation. Otherwise, how much association we found between stock prices and accounting numbers, it would just tell us they are highly correlated but no more than that could be learned.[8]

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[6] Though rarely mentioned, the stability of deep parameters is not logically deducible but to be confirmed empirically (Lucas 1981, 11-12).

[7] As Bicchieri (1987, 510) points out, Sargent (1984) notices this paradox, but refuses to accept its conclusion. Bicchieri (1993, ch. 1) is a revised version of Bicchieri (1987).

[8] Because learning leads to non-stationarity, we cannot learn by definition if we assume stationarity (Bicchieri 1987and Bossaerts 2002).

If deliberate standard setting, either conceptual or empirical, cannot offer a definite answer, why don't we let market participants decide as we do in most consumer goods? Next I consider another possible justification for deliberation from a different angle given investor primacy.

4. How Different Is Accounting Harassment from Sexual One?

Without knowledge of investors' preferences and beliefs, we cannot decide a priori which accounting standards are preferable. Neither can we use stock prices for standard setting if we assume the efficient markets hypothesis. Investors may not be that rational, but if stock prices are not informationally efficient, what is the point to use them first of all? (Sunder 1989, 457)

However, are we really in a terrible condition? Recent critical concern and suspicion about accounting numbers stem from the impression that liberal accounting has allowed managers to exploit investors. The situation is perceived to be a zero-sum or, worse still, minus-sum game.

Then, why do people continue to buy and hold securities issued by public corporations under the control of managers who are supposed to take advantage of poor accounting standards? A common response is that although we cannot get what we could and should get due to information asymmetry, we have to restore the primacy of investors over managers with proper corporate governance. But, information asymmetry is the result of division of labor, in which Adam Smith rightly saw the engine of prosperity more than two centuries ago. In order to enhance their own welfare, investors willingly delegate much of control to managers, receive service and pay in return as they have to pay for raw materials to make products. If the claim that the first best solution could be unattainable due to the positive cost of raw materials sounds odd, so does the claim on moral hazard too. This Nirvana approach seems to be applied too uncritically in the so-called agency problem (Demsetz 1969).

Moreover, what is considered a moral hazard problem may be a clever solution for profit maximization (Demsetz 1983). Seemingly outrageous on-the-job consumption should not be judged on its own. We have to pay managers what they are worth. If they prefer the package of more on-the-job consumption and less standard payment to the one in reverse combination and the former at most costs as much as the latter to investors, why not honor the choice of managers?

It is plausible to think liberal accounting makes this deal possible but stringent

accounting would not. Then, investors are happy to be harassed in accounting numbers. Much maligned earnings management is another possible device to enhance rather than destroy investors' wealth. Indeed many respected scholars[9] offer several plausible stories on the usefulness of earnings management. Those stories have one thing in common, however. Managers' real decisions are not independent of accounting (Demski 1990 and Sunder 1997). How to be measured influences what to do. This endogeneity together with the Demski impossibility theorem shown in Section 2 renders normative studies for optimal standards truly hopeless.

The management of Enron is criticized for improperly recording expenses as assets to inflate income figures. *Now* we know they were wrong, but were they simply malicious to distort the number? Many analysts as well researchers claim (partial) capitalizing of R&D expenditures is preferable to FASB mandated total expensing. Was the intention of the Enron management different ex ante?

Liberal accounting may enable management to become more aggressive as well as knowingly distort to their advantage. Accounting harassment can be considered a price for a risk associated with more aggressive management which ceteris paribus leads to a higher expected return with a higher risk. If it is another market risk factor,[10] it seems best to let each investor decide whether to take it or not. An investor who believes a reward for a risk is too small is not forced to buy securities with a high beta on the accounting harassment risk factor.

The same can be said about sexual harassment. If some potential employees agree to work in sexually harassed environments for higher payment, the government does not seem to have a right to poke its nose into such a private matter. Contract is not necessarily explicit. Many important conditions are left unspecified but everyone knows they are included in the deal. That is what implicit contract means.

This line of reasoning sounds innocuous to those familiar with economics. But still some uneasiness remains. Are we happy to let our daughters accept such a deal? Basu (2002 and 2003) gives this uneasiness a formal structure without arm waving too commonly seen in debating the topic. I follow a model of Basu (2002) verbatim, but give an interpretation of my own suitable for accounting harassment rather than sexual one.

The baseline production function of the economy $f(K)$ is assumed as follows:

(1) $$f'(K) > 0,\ f''(K) < 0\,.$$

[9] See Arya et al. (2003) and other works cited there.
[10] If a risk were idiosyncratic rather than systematic, it would not be rewarded.

In order to get the only explicit input, capital K, corporations in the economy offer securities to infinitely many investors. Each investor is identical with one exception and buys either of two different kinds of securities depending on his preference. Some corporations issue securities abiding by strict accounting procedures, while the others do making accounting numbers flexible. Therefore, the procurement of the total capital K consists of the one issued under no accounting harassment K_N and the other under accounting harassment K_H.

$$K = K_N + K_H .$$

In return for a risk induced by accounting harassment, K_H commands a higher expected return due to a larger expected output brought about by aggressive management. Let $q > 0$ denote a constant coefficient for added productivity, r_N a return for K_N, and p an added risk premium for K_H. I assume the harassment risk is orthogonal to the other market risk factors which are reflected in the non-harassment return. Then, the production function becomes:

$$g(K_N, K_H) = f(K) + qK_H$$

Thus the profit function becomes:

$$\pi(K) = f(K) + qK_H - r_N K_N - r_H K_H$$

$$r_H = r_N + p .$$

The two first-order conditions are:

$$\frac{\partial \pi}{\partial K_N} = f'(K) - r_N = 0$$

$$\frac{\partial \pi}{\partial K_H} = f'(K) + q - r_H = f'(K) + q - r_N - p = 0 .$$

Therefore, in equilibrium, the following two conditions must hold:

(2) $$f'(K) = r_N$$

$$p = q .$$

In other words, the marginal productivity of the baseline production function equals the return for non-harassment securities, while the premium for harassment equals the added productivity coefficient.

With the assumption (1) and the equilibrium condition (2), we can define the inverse of the marginal productivity, which turns out to be the demand function for capital.

$$D(r_N) = f'^{-1}(r_N) = K .$$

Next consider the supply side of capital. As mentioned above, the investors

represented by a real line [0, Z] are different on one dimension, the evaluation of disutility from accounting harassment. Each of them requires at least $c(x) \geq 0$ ($x \in [0, Z]$) additional reward for a unit of harassment securities depending on his evaluation. Therefore, they only buy them if $p = q \geq c(x)$. In other words, only those who believe they are more than compensated for the harassment risk buy these securities.

To make the exposition easier, I assume $c(x_1) > c(x_2)$ if $x_1 < x_2$. Then, $x = y(\rho)$, the inverse function of $\rho = c(x)$, is definable. Because $\rho = c(x)$ is a monotone decreasing function by definition, so is $x = y(\rho)$. That is, $y'(\rho) < 0$.

Thus, investors $x \in [0, y(p)]$ buy non-harassment securities, while those $x \in (y(p), Z]$ buy harassment ones.

The total supply of capital consists of non-harassment securities S_N and harassment ones S_H.

$$S = S_N + S_H$$

Let $s(\cdot)$ denote each investor's supply curve of capital assuming $s'(r) > 0$. It depends on not raw returns but (subjectively evaluated) risk adjusted returns. In the case of harassment securities, not r_H but $r_H - c(x)$ decides his investment. Then,

$$S_N = y(p)s(r_N)$$

$$S_H = \int_{y(p)}^{Z} s\left(r_N + p - c(x)\right)dx .$$

In market equilibrium $D = S$,

$$r_H^* = r_N^* + q$$

$$D(r_N^*) = S^* = S_N^* + S_H^* = y(q)s(r_N^*) + \int_{y(p)}^{Z} s\left(r_N^* + q - c(x)\right)dx$$

must hold. Thus, in equilibrium, investors $x \in [0, y(p)]$ get r_N^* for each unit of investment, while those $x \in (y(p), Z]$ receive $r_H^* = r_N^* + q$.

Now consider the case where strict accounting standards are adopted and effectively enforced. Now corporations only sell non-harassment securities. Then, the profit function becomes:

$$\pi(K) = f(K) - rK .$$

The first-order condition becomes:

$$f'(K) = r .$$

In market equilibrium,

$$D(r^*) = Zs(r^*)$$

must hold. In this regime, every investor, whether harassment averse or not, receive the same return r^* for each unit of non-harassment securities.

Now I want to establish that harassment averse investors prefer the non-harassment regime to the harassment regime though they can and do buy non-harassment securities even in the latter regime. What I have to do is to show $r_N^* < r^*$.

Suppose $r_N^* \geq r^*$. Because $f''(\cdot) < 0$ by assumption, the inverse function of the marginal productivity (also demand function for capital) $D(\cdot) = f'^{-1}(\cdot)$ has the following property:

$$D'(\cdot) = (f'^{-1}(\cdot))' < 0.$$

Therefore, by assumption,

$$D(r_N^*) \leq D(r^*).$$

or

$$y(q)s(r_N^*) + \int_{y(p)}^{Z} s\left(r_N^* + q - c(x)\right)dx \leq Zs(r^*).$$

Subtract $y(q)s(r_N^*)$ from both sides,

$$(3) \qquad \int_{y(p)}^{Z} s\left(r_N^* + q - c(x)\right)dx \leq Zs(r^*) - y(q)s(r_N^*) \leq Zs(r^*) - y(q)s(r^*) = \left[Z - y(q)\right]s(r^*).$$

The second inequality follows because $s(r_N^*) > s(r^*)$ by assumption.

If $u > y(q)$, then an investor u does not want to buy harassment securities, that is, $q > c(u)$ holds. Because $r_N^* \geq r^*$ by assumption,

$$r_N^* + q - c(u) > r^*.$$

Then,

$$s(r_N^* + q - c(u)) > s(r^*).$$

Therefore,

$$(4) \qquad \int_{y(p)}^{Z} s\left(r_N^* + q - c(x)\right)dx > \left[Z - y(q)\right]s(r^*).$$

But, (4) contradicts (3). Hence $r_N^* < r^*$.

It establishes that harassment averse investors $x \in [0, y(q)]$ strictly prefer the

non-harassment regime to the harassment one even if non-harassment securities are available under the latter regime. Moreover, not just those sharply harassment averse investors but also mildly averse ones who would buy harassment securities if offered under the harassment regime also prefer the non-harassment regime.

In equilibrium,

$$q = r_H^* - r_N^* > r_H^* - r^* = q'$$

must hold. q' may be called a *shadow* risk premium which is the difference between the return of harassment securities under the harassment regime and that of non-harassment securities under the *non*-harassment regime. Among those who would choose harassment securities, there are some for whom the following condition is met:

$$r_H^* - c(x) \le r^*$$

or

$$c(x) \ge r_H^* - r^* = q' .$$

Therefore, mildly harassment averse investors $x \in (y(q), y(q')]$ prefer the non-harassment regime to the harassment one. In total, investors $x \in [0, y(q')]$ prefer the non-harassment regime (Figure 1).

Suppose security markets used to be under strict accounting standards by which managers were required to abide. In my terminology, only non-harassment securities could be issued. The return on them was r^*, of course. Then, as some creative managers claimed that they should be given more discretion over accounting policies to enhance profitability, standard setters have allowed them to interpret the letter of standards more liberally but issue securities on condition that they make their liberal accounting policies publicly known. Because every investor is a price taker, initial investors who bought harassment securities did not change the prevailing (now non-harassment) return r^*, while they could receive a higher return. But, as the number of investors who buy harassment securities has increased, the return for non-harassment securities has decreased. Pareto improving transaction at the margin does not lead to a Parato superior state.

The moral of this story is that a usual argument for deregulation, freer accounting in our case, based on marginal analysis forgets the large number effect for the welfare of the economy. It is unproblematic to treat some variables as exogenous at the margin, but may be fatally problematic to do when we analyze policies inducing structural changes.

Up to this point, I have shown that the non-harassment regime is neither necessarily Pareto inferior nor superior to the harassment one. Then, which should we choose? Actually

there is no definite answer within the sphere of positive analysis. To complete the case for restriction on agreed-upon transactions, we need some normative ordering on preferences. I presume no decent (and even not so decent) people disagree to exclude illegitimate preferences such as "I want to kill as many Japanese as possible" from consideration. So let us concentrate on legitimate ones.

Basu (2002 and 2003) proposes a distinction between two kinds of legitimate preferences. He (2002, 13-14) claims "a particular preference is *maintainable* if a person has the right to that preference, while recognizing that he or she may have to pay a price for having this preference." If I want to live in Tokyo, I can do it but have to incur high cost for it. This is a typical maintainable preference. "On the other hand, an *inviolable preference* will be defined as a preference which not only does a person have the right to have, but he or she should not have to pay for acting on the basis of that preference." My wife's preference to work under no sexual harassment is most likely inviolable. This inviolable preference concept undoubtedly echoes Rawlsian maxmin principle. If freedom of contract were maximally honored and made my wife's wage lower than that under a legal ban on sexual harassment due to her refusal to be sexually harassed, her inviolable preference would be violated. This argument is persuasive enough for sexual harassment.

However, is it reasonable for accounting harassment? We have huge government securities markets as well as government insured term deposits besides securities issued by private parties. Moreover, the latter overwhelmingly cater to the economically advantaged. Considering the nature of securities markets, the inviolability of no accounting harassment seems much weaker than, say, that of no sexual harassment. Rather, investment in securities, at least those issued by private parties, can be considered a typical maintainable preference.

Still, we have found a hint in the maintainable/inviolable dichotomy for a better perspective on accounting standards. Next, I will elaborate on it a little further and conclude the paper.

5. Let Accountants Concentrate on Their Forte

Different from sexual harassment (though I admit what constitutes sexual harassment proper is debatable), it is difficult to swallow an argument for applying the inviolable principle to regulate accounting harassment. The mere existence of accounting harassment regulations such as Sarbanes-Oxley Act does no more show the theoretical, if not political, soundness of these regulations than the existence of high tariffs does that of protectionism.

Are these regulations a manifestation of the misguided pubic anger fuelled by

political opportunism? It is true that the accounting-is-bean-counting view implied in public discourse misses the subjective nature of the current accounting practices, which have been rather demanded by none other than investors, but the public surely have a right to invest without being lied outright. Though a substantial part of accounting is inherently subjective, there is still a large area where information is objective (inter-subjective) and consequently verifiable.

In line with this view on accounting more consistent with what is going on today, Glover et al. (2003) proposes a reporting framework called *Intertemporal Financial Statements*. In this framework, verifiable facts on the one hand and useful but unverifiable forecasts on the other hand are separately disclosed. Postmodernists notwithstanding, we have every reason to expect outside auditors to verify whether reported cash actually exists in bank accounts or corporate vaults, while some accrual items are decision useful but beyond the scope of verification. Accountants had better concentrate on what they have the ability to do, the verification of the verifiable. Ronen (2002) also advocates the separation of auditable accounting numbers and non-auditable ones when auditing is implemented in his *Financial Statement Insurance* (FSI) plan, which aims at making auditing business radically market-oriented.

If a large part of accounting information is better left for investors to examine at their own risk, the unification of accounting standards is a far less compelling idea than its advocates claim to be. Different investors have different ideas on what better information is aside from a small segment of verifiable numbers. As Dye and Sunder (2001) and Sunder (2002) claim, why not encourage competition among standard setters instead of picking just one of them as a de jure monopoly? In e-commerce security business, unregulated U.S. markets fare better than regulated U.K. ones (Jamal et al. 2003). Above all, we have different commercial codes state by state in the U.S. Unlike FASB, Delaware code is now a de facto standard not because it has been imposed by the federal government but because it has won market competition.

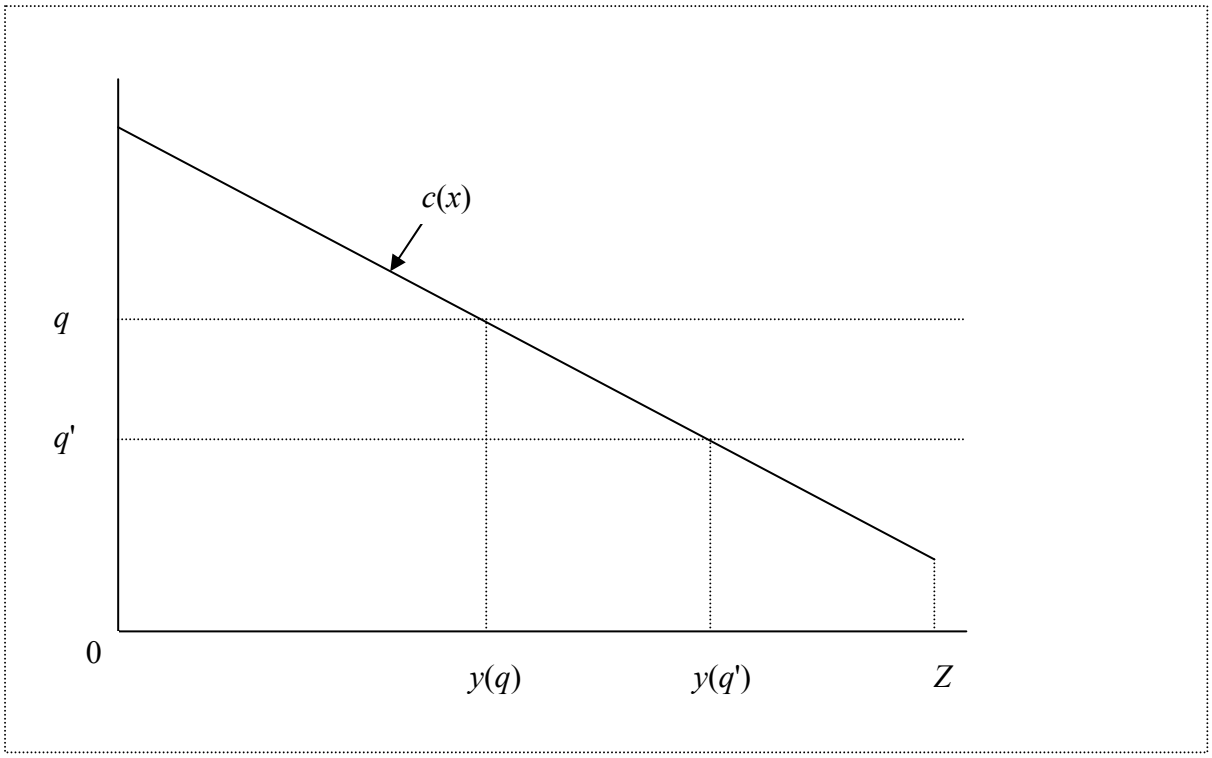
There is a Japanese proverb that says "Clear water does not breed fish." Moreover, over-sanitized environments would make investors less alert and prepared for analyzing accounting numbers, falling prey to determined evildoers. Most parents do not regard sending their adolescent daughters to a convent as the best way of preparation for their adult life.[11] We may need petty rascals to make and keep us immune to real tragedies in financial as well

[11] Taylor (1999) critically examines a recent trend in formal and informal sexual harassment regulations from a similar point of view.

as family life.

In conclusion, we are certainly entitled to expect that verifiable information be verified by competent professionals and liars together with their accomplices be duly punished. However, aside from this small part of accounting information, the caveat emptor principle on accounting numbers is more resilient and reasonable than critics of the principle assert. That is the only game in town if we do not want to kill the goose that lays the golden eggs.

Figure 1: How Many Want to Avoid Harassment?



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