Strengthening the Accounting Standard-Setting Process

Comments on the Financial Accounting Standards Board Bill (H.R. ____)

Prepared Testimony by

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NOTE: To help the reader follow the references in the testimony to the draft Bill, a copy of the draft Bill dated June 18, 2002, is appended at the end of this file.

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Chairman Stearns, Ranking Member Towns, and members of the Subcommittee, I am honored to be given this opportunity to testify here today.

The proposed H.R. Bill, the Financial Accounting Standards Board Act (The draft Bill), comes in the context of a crisis of trust that we see in the financial markets brought about by the weakened credibility of the US financial reporting system. Restoring the credibility and strengthening the financial reporting environment requires legislative and corporate action on several fronts, such as improving the corporate governance process, having better accounting rules, stronger enforcement of accounting rules (including improved staffing and funding of the Securities and Exchange Commission), stronger oversight of independent accountants and the auditing profession (including the creation of a new independent accounting board for
enforcement), improved education of managers about the need for transparency in disclosures, stronger investor protection, and so on. But these steps will be incomplete unless we also use the opportunity presented by the current crisis to examine ways to strengthen our accounting standard-setting process.

We are, of course, starting from a strong base of a well-respected, well-functioning and independent standard setting body, namely the Financial Accounting Standards Board. Nevertheless, the power of the FASB to set accounting standards comes from a tenuous relationship between the SEC and the FASB, starting with a historic and discretionary decision by the SEC in the late 1930s to allow the private sector to set accounting standards while retaining the legal power to overrule them. While the partnership between the SEC and the FASB has shown to be fairly workable over the years, the fact that the FASB has no independent legal basis does affect the effective functioning of the FASB in many practical ways. For example, it was a critical factor in the FASB’s lost battles of stock option accounting during the 1990s. Second, it has led to a suboptimal private funding mechanism in which the FASB is increasingly dependent on selling its publications at high cost to fund itself. Thus, any legislation to strengthen our standard-setting process must start with an unambiguous show of support from Congress for a strong and independent FASB by providing an independent, legal basis for its existence, followed by solutions for its funding. The draft Bill is a step in the right direction toward this goal. I provide additional discussion of this issue below.

Secondly, by proposing a path-breaking requirement that the FASB issue a “primary standard requiring adherence to principles,” this legislation takes the right step in moving the standard-setting process in the United States toward a “principles-based” approach, as opposed to the current approach to issuing standards and interpretations of high specificity, which has been
described by critics as “rules-based”. This part of the legislation is innovative, and below I discuss the financial engineering environment that has led to the current plethora of complex accounting rules, and the advantages of adopting a conceptual or principles-based standard setting approach taken in this draft Bill.

Providing the FASB an independent legal basis for existence and moving the standard-setting process toward a principles-based approach are the primary strengths of the draft Bill. However, trying to achieve these goals will also require addressing several key implementation issues. The foremost, and most daunting, implementation issue is a clear delineation of the roles of the FASB and the SEC in the development of accounting standards. Since the SEC already has the statutory authority (under the Securities Act and the Securities and Exchange Act) to develop as well as enforce accounting standards, it important for the draft Bill to include provisions that reconcile any newly recognized statutory role of the FASB to issue accounting standards with the powers already present in the SEC. The second, and related, implementation issue is the development of a viable, long-term funding mechanism for the activities of the FASB so that its current dependence on selling its own rules to fund its operations is eliminated. If the FASB were to have additional public responsibilities to set accounting standards and periodically report to Congress on the implementation of standards by corporations, then a funding plan to execute these public responsibilities must be addressed as well. The plan might be similar to the “direct, involuntary and independent funding” system proposed by the SEC for its planned Public Accountancy Board. Below I discuss in more detail what needs to be addressed in the draft Bill to better help achieve its goals.
Strengthening the FASB’s Legal Basis

The rich history of the development of accounting standard setting in the US has been recounted elsewhere.\(^1\) However, a brief review of the complex relationship that exists between Congress, the SEC and the FASB would help illustrate the theme that the FASB and the standard-setting process can benefit much from the granting of an independent legal basis for the FASB’s existence.

The SEC has long accepted and encouraged the role of the private sector in developing accounting standards. In Accounting Series Release No. 4 issued in 1938, the Commission stated its policy that financial reports that followed accounting practices for which “there was no substantial authoritative support” were presumed to be misleading. After the formation of the FASB in 1973, the SEC has reaffirmed this position and has stated in Accounting Series Release No. 150 (now part of Financial Reporting Release No. 1) that “principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support.”\(^2\) This view has also been expressed frequently by SEC commissioners and accountants in speeches and testimonies over the years.

Without this strong and unwavering support from the SEC, there would be no private sector standard setting and there would be no FASB. This is because only the SEC has the statutory power to ensure that its corporate registrants follow the accounting rules set forth by the FASB. Thus, even if the SEC were to leave the standard setting activity completely in the hands of the

\(^1\) For a good reference, one should start with the writings of my colleague Professor Stephen A. Zeff of Rice University. I gratefully acknowledge my discussions with him related to this testimony.

FASB subject to its oversight, the effectiveness of the FASB to develop accounting standards depends on the willingness of the SEC to enforce the resulting standards.

While the FASB has generally received the open support of the SEC to continue to set accounting standards, this support has not been without problems. The SEC, after all, does have the statutory power to overrule the FASB, and not surprisingly, business executives and others potentially affected by accounting standards (sometimes referred to as the constituents of the FASB) are fully aware of this underlying weakness in the power of the FASB. The constituents of the FASB, in effect, know that “the buck doesn’t stop here,” and so they try to go around the FASB by seeking intervention from the SEC or Congress whenever the FASB ventures into areas of rule making that are detrimental to their interests. Further, the SEC and Congress have demonstrated, albeit only rarely, their willingness to pressure the FASB to reconsider its decisions for what might well be political reasons rather than conceptual reasons.

The most glaring example of such an intervention was with respect to FASB’s project on stock options accounting, when the US Senate passed a non-binding resolution in opposition to the FASB’s position that the cost of stock options should be shown by corporations as an expense.³ Responding to efforts in Congress to overturn the FASB’s accounting rule, SEC effectively advised the FASB to shelve its accounting rule requiring the expensing of stock options in favor of a weaker rule requiring just footnote disclosures. The then SEC Chairman, Mr. Arthur Levitt, described the SEC’s role in this episode in a recent media interview as follows: “My concern was that if Congress put through a law that muzzled FASB, that would kill independent standard setting. So I went to FASB at that time, and I urged them not to go ahead

with the rule proposal. It was probably the single biggest mistake I made in my years at the SEC…"4

There were other, more frequent, cases of regulatory interventions during the earlier period of the FASB, such as the oil and gas accounting controversy in the 1970s and the inflation accounting controversy in the 1980s. It is true that these early episodes quickly led to a more stable and functioning arrangement in which the SEC has evolved into an ever-present and influential behind-the-doors partner during the standard-setting process. The SEC actively participates during the discussions that lead to major standards, and also participates in the meetings of the Emerging Issues Task Force.

Despite the current working relationship, the lack of a strong legislative basis for the FASB’s existence will generally mean that the FASB would always face the risk of being second-guessed by regulators. The main beneficial effect of the draft Bill would be that it would result in Congress putting into law unequivocally what has been the official position of the SEC since 1938. The statement in section 3 of the draft Bill, that the “standards of financial accounting and reporting promulgated by the FASB shall be authoritative for the purpose of determining compliance with generally accepted accounting principles by any person under any Federal regulatory program,” essentially codifies in almost exact language what is already present in SEC’s Financial Reporting Release No. 1 and formerly Accounting Series Release No. 150.5 It seems clear that this elevation of the FASB’s role as stated in SEC’s FRR No. 1 into an independent legislative fact would help considerably strengthen the FASB and consequently its standard-setting process.

4 See interview with Levitt in “Bigger than Enron”, Frontline, PBS, June 22, 2002. For excerpts, see http://www.pbs.org/wgbh/pages/frontline/shows/regulation/congress/
5 See my earlier quote for the exact language from the SEC’s FRR 1.
Principles-Based Standards

A surprising provision in the draft Bill is in section 5 subsection (c), titled “Primary Standard Requiring Adherence to Principles.” This provision requires the FASB to promulgate a “primary standard requiring the application of the principles articulated in subsection (a) of this section to financial accounting and reporting.” In turn, subsection (a), titled “General Principles”, calls for the FASB to follow certain principles when promulgating its standards. The principles listed here are identical to what the FASB already has proclaimed as its guiding principles in its Statement of Financial Accounting Concepts No. 1. In essence, the “objectives of financial reporting” of the FASB Concepts Statement No. 1 require that financial reports should provide information that is useful to investors and other users in making rational investment, credit, and similar decisions.” The draft Bill codifies this and the related objectives of Concepts Statement No. 1.

So one might ask: if the draft Bill essentially codifies what is already in the FASB’s Concepts Statements, what exactly is new in section 5 (c)? Surprisingly the newness is contained in the additional requirement in the section: “Except as provided in paragraph (2), such primary standard shall prohibit the application of any other standard of financial accounting and reporting promulgated by the FASB in a manner, or with a result, that fails to comply with such principles.” In essence, this provision says that a company’s financial reports must be prepared in such a way that the “primary standard” of providing information that is useful and comprehensible to investors should be paramount, and should not be violated even if the

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company can claim that it has followed the letter of all other standards. One could thus interpret the requirement of section 5 (c) as a new responsibility requirement for corporations to ensure that their financial reports are not misleading to investors, regardless of whether they have technically followed all the other rules of the FASB.

The provision also can be interpreted to impose a new standard for the FASB to follow as it makes new accounting standards – namely that such standards should not violate the primary standard. However, a history of the development of the Concepts Statement No. 1 would show that the FASB itself had always treated the various Concepts Statements as similar guides. The Concept Statement No. 1 and six other related Concepts Statements resulted from a so-called Conceptual Framework project undertaken by the FASB soon after its inception in 1973. The project was supposed to help the FASB develop a unified framework of financial reporting that can guide its subsequent standard-setting efforts and provide a measure of theoretical consistency to the resulting standards.

The FASB’s Conceptual Framework project was the first such major effort by any standard setter to develop a principles-based standard-setting process. More recently, the International Accounting Standards Board (IASB) has generally expressed an interest in following a principles-based approach to standard setting. For example, Sir David Tweedie, Chairman of the IASB, spoke favorably of a principles-based approach in a testimony to the US Senate on February 14, 2002, as follows:7 “Both international standards and U.S. GAAP strive to be principles-based, in that they both look to a body of accounting concepts. U.S. GAAP tends, on the whole, to be more specific in its requirements and includes much more detailed

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7 Prepared testimony of Sir David Tweedie, Chairman of International Accounting Standards Board, to US Senate Committee on Banking, Housing, and Urban Affairs, February 14, 2002.
implementation guidance…” Chairman Tweedie went on to state his view of how the IASB would set accounting standards.\(^8\)

“The IASB has concluded that a body of detailed guidance (sometimes referred to as *bright lines*) encourages a rule-book mentality of "where does it say I can't do this?" We take the view that this is counter-productive and helps those who are intent on finding ways around standards more than it helps those seeking to apply standards in a way that gives useful information. … We [instead] favour an approach that requires the company and its auditor to take a step back and consider whether the accounting suggested is consistent with the underlying principle. … Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures.”

While the FASB and the IASB both seem committed to issuing principles-based standards, this draft Bill makes such a process both mandatory for the FASB and additionally requires regulatory compliance by corporations with the principles. The provision does raise significant implementation questions, since the burden of monitoring compliance with the provision and of making sure that financial statements follow the new primary standard would presumably fall on external auditors and the SEC. Given the lack of adequate public discussion in the US about what a principles-based approach would mean for standard setting or for enforcement, my belief is that these provisions of the draft Bill, while innovative, will require further deliberations by the Subcommittee as to its enforcement and funding implications.

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\(^8\) *Ibid.*
**Implementation Issues**

Providing a stable legal basis for the FASB’s standard-setting process raises the issue of whether a legislative enactment of what is already in the SEC’s FRR No. 1 will in effect change the statutory powers of the SEC with respect to standard setting. I will leave discussion of this issue to others having expertise in legal matters such as this, though it is at least clear to me that the draft Bill needs to include an explicit reconciliation of the SEC’s statutory authority with the new provision, and a statement of how the FASB’s standards would be enforced. The potential implementation problem is that the SEC has the statutory authority (under the Securities Act and the Securities and Exchange Act) to set and enforce accounting standards, while the draft Bill additionally recognizes the role of the FASB in setting accounting standards. There is the possibility, then, of both the SEC and the FASB setting standards which might potentially be in conflict, with only the SEC having the power to enforce standards. Hence the draft Bill needs to set forth a clear, functioning structure that can guide the working relation between the FASB and the SEC.

A second major implementation issue is whether the FASB will have the funds available to take on the responsibilities set forth in the draft Bill, especially if the newly designated legal standing for standard setting leads to increased standard-setting responsibilities. In addition, the draft Bill requires the FASB to provide an annual report to the President and to Congress, which may turn out to be expensive to comply with because of a key provision in the draft Bill that the report should include “an evaluation by the FASB of the extent of the compliance of financial statements” by corporations. This provision may well require extensive and continuous monitoring by the FASB of the corporate world’s use and abuses of financial reporting rules –
similar to what is currently done by hundreds of staff members at the SEC’s Corporation Finance Division.

The development of a viable, long-term funding mechanism for the activities of the FASB is certainly an issue that merits discussion because the current operating budget of the FASB comes mainly from two sources. According to the 2001 Annual Report of the Financial Accounting Foundation (the parent organization of the FASB), the FASB received $5.1 million in 2001 from “net contributions” from donors and $14.8 million from “subscription and publication sales.” Netting the “direct cost of sales” of these publications of $1.6 million, the FASB received $13.2 million from the sale of subscriptions and publications dealing with its accounting standards. This means that 72 percent of FASB’s operating revenues in 2001 came from the sale of publications describing or explaining its rules. The FASB may even need to keep issuing new and more complex rules to keep the funds inflow needed for its operations. The FAF 2001 annual report notes this reality as well, and states that the revenue from publications is “dependent upon the results of activities of the [Board’s] technical agendas.”

It would be useful if the draft Bill addresses this situation by including proposals for a more stable and independent funding plan for the FASB to execute its public responsibilities. The plan might be similar to the “direct, involuntary and independent funding” system proposed by the SEC Chairman Harvey Pitt, in a testimony to the US Senate, for the SEC’s planned Public Accountancy Board.9 In the same testimony, Chairman Pitt also specifically addressed the funding of the FASB and said that it “should be more secure and should strengthen both the reality and the appearance of independence. Funding should be made involuntary.”

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9 Prepared testimony of Harvey L. Pitt, Chairman of the SEC, to US Senate Committee on Banking, Housing and Urban Affairs, March 21, 2002, Section 2.1.3.
Conclusion

When it comes to commenting on the current US accounting standard setting environment, it seems almost mandatory to mention that we have the best and the most trusted financial reporting system in the world. Whether such a claim is true or not, it is a fact that the Enron meltdown and the various accounting reporting controversies that have followed this year have shaken investors’ faith in our financial reporting system. It is now time to fix the mess and restore investor credibility in the financial reports. While the SEC and Congress are addressing needed changes in the areas of corporate governance, investor protection, prosecution of management fraud, and regulation of independent accountants, the issue of improving our financial standard-setting process does need the attention of Congress as well.

The draft Bill’s proposal to codify the current SEC position on the role of the FASB in standard setting is a step in the right direction, and so is its push to make the standard setters move toward principles-based standards. However, these proposals do raise several daunting implementation issues and some new conceptual issues as well. These concerns need to be addressed effectively as the draft Bill moves forward in your Committee and Congress. Thank you for the opportunity to present my views before your Committee. I will be glad to answer any questions from the Committee members.
A BILL

To preserve the integrity of the establishment of accounting standards by the Financial Accounting Standards Board, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the “Financial Accounting Standards Board Act”.

SEC. 2. DEFINITIONS.

As used in this Act—

(1) FASB.—The term “FASB” means the Financial Accounting Standards Board.

(2) FEDERAL REGULATORY PROGRAM.—The term “Federal regulatory program” means a program enacted under the authority of the Commerce Clause of the Constitution and providing for the regulation of the interstate or foreign commerce of the United States, or the use of the means or instrumentalities of such commerce.

(3) PERSON.—The term “person” includes corporations, companies, associations, firms, partnerships, societies, and joint stock companies, as well as individuals, but does not include an agency or instrumentality of Federal, State, or local government.

SEC. 3. STANDARDS AUTHORITATIVE.

The standards of financial accounting and reporting promulgated by the FASB shall be authoritative for the purpose of determining compliance with generally accepted accounting principles by any person under any Federal regulatory program.
SEC. 4. DUTY OF FASB.

The duty of the FASB shall be to establish and improve, after independent and impartial deliberation, standards of financial accounting and reporting for any person.

To accomplish its duty, the FASB shall act to—

(1) improve the usefulness to present and potential investors, creditors, and other users, of financial reporting made by firms in interstate commerce focusing on the primary characteristics of relevance and reliability;
(2) keep standards current to reflect changes in methods of doing business and changes in the economic environment;
(3) consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;
(4) promote the international convergence of accounting standards concurrent with improving the quality of financial reporting; and
(5) improve the common understanding of the nature and purposes of information contained in financial reports.

SEC. 5. REQUIREMENTS FOR ESTABLISHMENT OF ACCOUNTING STANDARDS.

(a) GENERAL PRINCIPLES.—In promulgating and revising standards of financial accounting and reporting, the FASB shall follow the following principles:

(1) Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.
(2) Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of the securities or loans.
(3) Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners’ equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources.

(b) OPERATING OBJECTIVES.—The FASB shall promote the following objectives in the conduct of its activities:

(1) To be objective in its decision making and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.
(2) To weigh carefully the views of its constituents in developing concepts and standards. However, the ultimate determinant of concepts and standards must be the FASB’s judgment, based on research, public input, and careful deliberation about the usefulness of the resulting information.

(3) To bring about needed changes in ways that minimize disruption to the continuity of reporting practice, including establishment of reasonable effective dates and transition provisions when new standards are introduced. Change should be evolutionary to the extent that it can be accommodated by the need for relevance, reliability, comparability, and consistency.

(4) To review the effects of past decisions and interpret, amend, or replace standards in a timely fashion when such action is indicated.

(c) PRIMARY STANDARD REQUIRING ADHERENCE TO PRINCIPLES.—

(1) PROMULGATION REQUIRED.—The FASB shall promulgate a primary standard requiring the application of the principles articulated in subsection (a) of this section to financial accounting and reporting. Except as provided in paragraph (2), such primary standard shall prohibit the application of any other standard of financial accounting and reporting promulgated by the FASB in a manner, or with a result, that fails to comply with such principles.

(2) DEVIATIONS EXPLAINED AND JUSTIFIED.—The primary standard promulgated pursuant to this subsection may allow for deviation from the application of such principles only if an explanation and justification for the basis of the deviation is specifically articulated and made public.

(d) ESTABLISHMENT OF ADDITIONAL STANDARDS.—

The FASB shall develop additional standards of financial accounting and reporting to address issues relating to—

(1) off-balance-sheet accounting practices and standards, and accounting requirements for special-purpose entities, in a manner that is based on principles for determining bona fide economic control; and
(2) requirements for marked-to-market accounting, including consideration of the application of fair value to agreements involving commitments on the part of an issuer.

(e) ADDITIONAL PROJECTS.—

(1) FAIR VALUE PROJECT.—Within one year after the date of enactment of this Act, FASB shall complete work on the project entitled ‘‘Measuring All Financial Assets and Liabilities at Fair Value’’.

(2) REVENUE AND LIABILITY RECOGNITION PROPOSAL.—Within 18 months after the date of enactment of this Act, FASB shall complete work on the proposal entitled ‘‘Proposal for new agenda project: Issues relating to the recognition of revenues and liabilities’’.
SEC. 6. PRESERVATION OF AUTHORITY.

Nothing in this Act shall be construed to limit—

(1) the authority of the Securities and Exchange Commission under the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)); or
(2) the authority of any other Federal agency under the laws applicable to a Federal regulatory program administered by such agency.

SEC. 7. REPORTS.

(a) FASB REPORTS.—

(1) ANNUAL REPORTS.—The FASB shall transmit annual reports to the President, the Committee on Energy and Commerce of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate.

(2) CONTENTS OF REPORTS.—Each report transmitted under this subsection shall include the following:

(A) ASSESSMENT OF RESOURCES.—An assessment by the FASB of the resources available, and the sufficiency of those resources, to carry out the purposes and requirements of this Act.

(B) EVALUATION OF COMPLIANCE.—An evaluation by the FASB of the extent of the compliance of financial statements with the standards of financial accounting and reporting promulgated by the FASB and with the requirements, objectives, and principles of sections 4 and 5.

(C) PROGRESS ON UNRESOLVED ISSUES.—A statement by the FASB of the progress made by the FASB in the resolution of unresolved accounting standards issues.

(D) PROGRESS ON TREATMENT OF INTANGIBLE ASSETS.—A statement of progress made by the FASB in modernizing and improving the accounting treatment for intellectual property and other intangible assets.

(3) REPORT ON PRIMARY PRINCIPLE RESOLUTION.—The first report transmitted under this subsection shall indicate the resolution by the FASB of the issues identified in section 5(c).

(b) GAO REPORTS.—

(1) ANNUAL REPORTS REQUIRED.—The Comptroller General shall transmit annual reports to the President, the Committee on Energy and Commerce of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate on the FASB.

(2) CONTENTS OF REPORTS.—Each report transmitted under this subsection shall include the following:
(A) PROGRESS ON UNRESOLVED ISSUES.— An evaluation of the FASB’s progress in resolving unresolved accounting standards issues, including a description of such issues, the plans and timetables concerning, and resources available for, the resolution of such issues, and the reasons for any delays in resolving such issues.

(B) ASSESSMENT OF FASB INDEPENDENCE.—An assessment of the extent to which the FASB has maintained its independence and objectivity, including an assessment of any impairment of such independence and objectivity resulting from the methods by which the FASB obtains the resources required for its operations.

(C) EVALUATION OF PROCEDURES.—An evaluation of the procedures followed by the FASB in accounting standard setting, including the due process accorded to interested parties, the efficiency of FASB procedures in resolving issues, and the extent of the compliance by the FASB with its own procedural requirements.

(c) UNRESOLVED ACCOUNTING STANDARDS ISSUES.—For the purposes of this section, the term “unresolved accounting standards issue” means the open agenda items of the FASB and the FASB’s Emerging Issues Task Force, and any other issues that this Act has added to that agenda.
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