The FASB
The People, the Process, and the Politics

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Third edition

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FOREWORD

The 20 years that have passed since the founding of the Financial Accounting Standards Board give it a life nearing that of its longest-lived predecessor. Few could have predicted the events of those two challenging decades but the Board's viability and influence have been demonstrated time and time again in both domestic and international arenas. In particular, the Board's Conceptual Framework and its open and participatory process have dramatically changed the nature, methods, and language of debate about accounting issues.

The Board is a unique private sector organization that has no statutory authority but that nonetheless bears a responsibility granted by Congress to the Securities and Exchange Commission. Success in this unusual role is possible because of the tension between the SEC and the private business sector. The SEC is empowered to set accounting standards but is also less than overly prepared or eager to exert that power. Many managers within the business sector, in turn, would rather operate under few, if any, standards and prefer that those standards be established outside the government. Thus, actions that permit or even cause the Board to fail create the risk that the SEC would be required to take over standard setting.

As a result, the Board occupies a very fragile position. Although it was created to be an instrument of change, it must do its work in a world that fiercely protects the status quo. Because each constituency tries to use the system to defend its own particular interests, the FASB requires nurturing by those who want it to succeed, especially those who believe that the public's interest is paramount. That nurturing can only be accomplished if the public interest dimensions of financial accounting and reporting are fully understood by all who participate in the process.

Miller, Redding, and Bahnson have written a flavorful book that is filled with insight available only to diligent, informed observers of standard setting. As a result, those who study this book will understand more about the need for standards, the process used to create them, the major participants in that process, and the immense difficulty of balancing the public interest against the individual interests of the numerous constituents. This deeper understanding is essential to responsible participation in the standard setting process and to the survival of a viable, independent Board that is capable and worthy of its responsibilities. This book will be invaluable to those readers who have either or both of these objectives in mind.

Raymond C. Lauver
FASB Member 1984–1990
New Canaan, Connecticut
November 1993

PREFACE

The overall goal of this third edition of *The FASB: The People, the Process, and the Politics* is the same that we pursued in the first two editions—we want to provide a complete, clear, and objective description and evaluation of the Financial Accounting Standards Board. Despite the significance of its work, the power vested in it, and its relatively small size, the FASB is neither aloof nor impersonal but is very much involved in personal and institutional interactions with its constituencies. After 20 years of setting the direction for progress in financial accounting and reporting, the Board remains focused on its main objectives and sensitive to the interests of those who are affected by its activities. Despite the many criticisms directed toward them from all corners, the people of the FASB continue to carry out their process amid the significant and varied political forces that they are subjected to.

ORGANIZATION AND NEW FEATURES OF THE THIRD EDITION

Perhaps the most important new feature for the third edition is the addition of Dr. Paul Bahnson as our coauthor. Paul is a former member of the FASB's staff through his service as a postgraduate intern during his doctoral studies. He is now a member of the faculty of the University of Montana, and has continued to keep an eye on the Board through his teaching and research. His specific contributions to the project are too numerous to mention, and much of what we have accomplished is due to his efforts.

The book begins with a Prologue that consists primarily of five articles from the business press about a financial reporting issue: mark-to-market accounting for investments. Through the articles, the reader can see the issue emerge, attract attention from regulators, create controversy, and then receive an authoritative resolution, despite the heavy opposition leveled against the FASB. This section of the book provides a bird's-eye view of what the Board is, what it does, and how political factors affect its activities.

As in the prior editions, Chapter 1 lays a foundation for the rest of the book. It provides a macrolevel explanation of the reasons for the importance of financial accounting for the operation of the capital markets and the overall economy. New to this edition is an explicit discussion of the noninvesting public's interest in financial reporting. The chapter also explains why accounting issues need to be resolved authoritatively, and then describes why the FASB was formed and the sources of its authority. The chapter also considers the question of whether the Board is political, and comes to the conclusion that it clearly is.

Chapter 2 examines the structure for setting standards that was created in response to the proposal by the Wheat Study Group of the American Institute of Certified Public Accountants in 1972. It shows how this structure has been kept viable through both internal and external influences. A new section presents information about potentially negative changes in the composition of the board of trustees. This chapter has proven to be especially interesting in the prior editions because of its introductions to the people of the FASB. As before, we have not simply described positions in an organization chart but have provided information about the personalities of the people who give the organization its expertise and vitality. We have included new information on all seven Board members, including the two newest members appointed in 1993. We have expanded our description of the Research and Technical Activities staff, which often operates behind the scenes without the attention that is normally directed at the Board. The appendix to the chapter describes the FASB's two predecessor bodies (the Committee on Accounting Procedure and the Accounting Principles Board) and explains why they were disbanded and replaced.

In Chapter 3, we describe the due process that the FASB uses as it searches for the right questions and possible answers. Because we are relatively unhindered by the space limitations that affect other books, we are able to go beyond other published descriptions of these activities. We believe that readers will gain from learning that the system's flexibility allows it to adapt to changes in the environment and the unique factors surrounding each project, and that it makes a great deal of political sense to have a due process that includes all constituents. The third edition has several changes from the second. First, it now includes a full description of the hierarchy of authoritative sources of generally accepted accounting principles created in Statement of Auditing Standards No. 69 in 1991. Second, it has been revised to use the mark-to-market project to illustrate each of the stages of the process. Third, it includes five complete comment letters for this project in an exhibit that lets the reader see the kind of information that constituents provide to the Board, as well as letting them have a taste of the attitudes that the letter writers often display. As before, we are convinced that the chapter offers something new to virtually everyone who reads it.

Chapter 4 closely examines and evaluates the FASB's conceptual framework, which continues to have the distinction of being the Board's most important and controversial project. The analysis includes inside views that were made possible by Paul Miller's position as a faculty fellow on the Board's staff during the controversial recognition and measurement phase of the project. His status as a member of the staff team gave him special insights into the issues as well as the personal and political pressures that significantly affected the project's final form. The chapter also summarizes the contents of each of the six Statements of Financial Accounting Concepts in a way that is decidedly different from those provided in other places. A major change for the third edition came from a very useful suggestion from one of our reviewers. Specifically, this discussion has been moved one chapter earlier to allow the framework's concepts to be used in analyzing the issues described in the next chapter.

Chapter 5 describes a series of major accounting issues that have occupied the attention of the FASB and its predecessors over the last 50 years. Some issues must be resolved again when they take on new forms in different transactions and industries; other issues have reappeared simply because of growing dissatisfaction with a previous answer. As before, we did not set out to describe all major issues, but we do present enough to show readers how nontechnical factors affect accounting standards. As a result, it shows clearly that the standards-setting process is and has always been as much political as logical. The third edition includes several changes, including a series of short additions that show how the Conceptual Framework did affect or could have affected the FASB's standards. The chapter now presents a new section on issues related to employee compensation, including the very controversial projects on pensions, medical benefits, and compensation paid with stock. The chapter also has been updated to describe the requirements of new standards on consolidated financial statements, the statement of cash flows, employee health benefits, income taxes, and financial instruments.

Chapter 6 (previously called an *epilogue*) focuses on the FASB's future and the factors that are likely to affect its ability to continue fulfilling its mission. More so than any other chapter, Chapter 6 provides explicit descriptions of the political factors that affect the FASB. The contents of the chapter include the issues of whether standards setting should take place in the public or private sector, whether standards overload exists, and whether the Board is dominated by financial statement preparers. An important new feature for the third edition is a discussion of international accounting standards and issues, including a description of some of the steps the Board has taken in this arena. Another especially important addition is a detailed listing of actions taken by the Business Roundtable and other preparers with the apparent goal of diminishing the FASB's ability to create new standards. This section includes details that have not been widely published before.

WHO SHOULD USE THIS BOOK?

Our original concept for the first edition was that this book would be targeted for use in colleges and universities, primarily as a supplemental textbook for courses in intermediate accounting, advanced accounting, and accounting theory, as well as other courses where students need to learn about the political nature of standards setting. To help instructors in these settings, the book presents questions and exercises for each chapter at the end of the book. We have also prepared an Instructor's Manual that includes solutions and suggestions for conducting classes around the book.

In addition, the past has shown that this book has been an important resource in other settings. For example, a copy of the book is a standard component of the reading material provided to new FASB employees. We have also found that many journalists who cover financial reporting issues have read this book in order to gain a deeper understanding of the Board. It has also been especially gratifying to find numerous footnotes to the book in research papers and other textbooks, which indicates that it has become the standard reference work on the FASB.

Beyond these uses, we remain convinced that this book is highly suitable for continuing education for practicing accountants, regardless of whether they are engaged in public or private accounting. And, it should be read by others, particularly corporate managers, who need to understand much more about the Board and the important part it plays in their professional environment. By learning what this book has to offer, they can more easily cope with the changes that the Board produces.

ACKNOWLEDGMENTS

In expressing appreciation for the efforts of others, we need to begin with the many people of the FASB who helped us. At the top of the list for her patience, friendship, promptness, encouragement, and cheerful cooperation is Debbie Harrington, the Board's public relations counsel. Of course, we express great thanks to the chairman of the Board, Denny Beresford, and the other six members who were serving in 1993 (Jim Leisenring, Bob Swieringa, Joe Anania, Bob Northcutt, Tony Cope, and Neel Foster), each of whom kindly consented to give us some of their time and insights into their personal lives. The same sort of appreciation is expressed to Tim Lucas, director of Research and Technical Activities, and other staff members, including Jane Adams, Carl Bass, Teri List, Ann Perry, and Bob Wilkins. A special thanks goes to former Board member Ray Lauver for providing us with the book's foreword.

Thanks also to those who reviewed materials for us, including: Alan D. Campbell of Arkansas State University, Bruce E. Committe of University of Vermont, Raef Lawson of SUNY–Albany, and Tommy Moores of University of Nevada, Las Vegas.

We also benefited greatly from the efforts of Bradley-Allison Smith, a graduate student at the University of Colorado at Colorado Springs, for helping us compile the reading lists that appear at the end of each chapter.

Paul Miller
Rod Redding
Paul Bahnson

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PROLOGUE

The Life Cycle of an Accounting Issue

The following articles from the business press are presented here in order to illustrate a number of important points about the process used in the United States for setting financial accounting standards. The articles pertain to the Financial Accounting Standards Board's "mark-to-market" project, which produced a standard that created new practices to be used in accounting for investments in marketable equity and debt securities. The reader should observe the following specific points:

- While some standards-setting issues involve how to account for new events and transactions, others, like the issues in the mark-to-market project, are concerned with possible improvements in the accounting for transactions and events that have been around for a long time. The central issue in the mark-to-market project involved the question of whether companies (especially financial institutions) should report their investments at fair value instead of at the lower-of-cost-or-market, which was the required practice at the time this issue arose.
- Different groups within the financial reporting community had different positions on how investments should be reported. The groups included management, investors, creditors, investment analysts, independent auditors, and government regulators.
- Several groups can create generally accepted accounting principles. In this case, the Accounting Standards Executive Committee (AcSEC), a rule-making body of the American Institute of Certified Public Accountants (AICPA), first examined the issue and recommended that financial institutions disclose but not record fair values of their investments.

- The Securities and Exchange Commission (SEC), the federal agency with statutory authority to establish accounting rules for public companies, was not satisfied with AcSEC's decision and essentially nullified the rule before it was ever put into effect. The SEC did not propose an alternative rule but rather called on another institution within the accounting profession for additional guidance.
- The Financial Accounting Standards Board (FASB) took over the task of resolving this issue.
- The FASB's due process for resolving the issue involved a number of steps, beginning with adding the project to its agenda, continuing with much deliberation, and ending with the issuance of a Statement of Financial Accounting Standards. The elapsed time between the FASB's vote to add the issue to its agenda and the issuance of the Statement was 24 months.
- Although the FASB's due process has a required sequence of events, some variation within that sequence is necessary. For example, FASB member Jim Leisenring's reversal of his position early in 1992 during the process required the Board to reexamine the issues and increased the time used to resolve this issue.
- In addition, this project illustrates the influence that constituent groups attempt to bring to bear on the FASB through their input. The various groups that expected to be affected by the outcome of the project attempted to shape the Standard. Particular attention should be given to the September 21, 1992, article from *Accounting Today* that summarizes the views of several interested groups, including the managers of financial institutions.
- Everyone involved in the debate seemed to think that the numbers reported in the financial statements make a difference. Of course, this fact does not prove that financial accounting numbers actually affect decisions, but it does show that the information in the financial statements is thought to be important. Because the numbers are thought to be important, it follows that issues concerning them are also important.
- The reporters for the business press called on people from many different occupations for their views on the issue. The articles quote specific comments from corporate representatives, SEC and Treasury officials, an investment analyst, and a representative of an accounting firm. Also notice that the references made to comments by the FASB's director of Research and Technical Activities, a project manager, and a Board member. Because of the significance of Board member Jim Leisenring's changed positions on the issues, his comments were quoted directly in the press. Generally, only the FASB's staff speaks to the business press in order to allow Board members to keep their views to themselves, and to thereby provide them with more flexibility in reaching a consensus.

September 17, 1990

Rules Changes for Accountants Worrying SEC

BY KEVIN G. SALWEN AND SANDRA BLOCK
Staff Reporters of *The Wall Street Journal*

WASHINGTON—The Securities and Exchange Commission expressed dismay at new standards the accounting industry has adopted for financial institutions, and the agency urged that the standards be tightened sharply.

At issue is the way financial institutions, mostly banks and thrifts, account for debt securities they hold for investment. Under current accounting rules, such securities are marked at their cost, while debt securities held for short periods and used as trading assets are marked to market price.

The SEC, in a letter to an accounting industry panel, said the current method has "repeatedly proven to be irrelevant to valuing investment portfolios." The agency said all debt instruments should be marked to market price.

The letter—from Edmund Coulson, the SEC's chief accountant, and Robert Bayless, chief accountant of the SEC corporation finance division—follows an effort last week by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants to change the current rules. The committee voted Thursday to force banks to disclose in notes to the financial statements information about the amortized cost and market value of their investment holdings.

The SEC wasn't satisfied with the vote, which represents a significant pullback from earlier committee proposals that would have required financial institutions to report in financial statements themselves any changes in the portfolio value of debt held as investments. The committee's original plan drew protests from accountants and bankers, who argued that marking all debt securities to market would cause wide swings in earnings reports.

The SEC dismisses that view. "Any volatility is a product of a financial institution's investment portfolio," the agency said in its letter.

The SEC letter argues that the panel shouldn't "seek to redefine the distinctions between 'trading' and 'investment' securities, but to recognize that these distinctions cannot justify permitting a reporting company to overvalue assets."

SEC Chairman Richard Breeden made similar comments earlier last week to the Senate Banking Committee. He said Friday that he is worried that some banks' financial statements should carry the caution "once upon a time" at the top of the page.

Mr. Breeden cited the thrift crisis as a clear illustration of the flaws of the current accounting system. In an interview, he explained that in 1980, when Congress was considering the proposals to deregulate the thrift industry, S&Ls were showing a positive net worth of $36.2 billion. But, on a mark-to-market basis, their net worth was actually "somewhere between minus $78 billion and minus $118 billion," according to later research.

The failure of thrifts to reflect their true value accurately, Mr. Breeden said, "was a significant factor in delaying the understanding by the public of the actual condition of the thrift industry."
