



The **FASB**

The People, the Process, and the Politics

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Fourth Edition

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The FASB

The People, the Process,
and the Politics

To:
Diana, David, Greg, and Angela
Brenda, Mike, and Kim
Kathie, Sara, and Andy

PREFACE

The overall goal of this fourth edition of *The FASB: the People, the Process, and the Politics* is the same that we pursued in the first three editions: 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 nearly 25 years of setting the direction for progress in financial accounting and reporting, the Board has generally stayed focused on its main objectives while remaining 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 conduct their process amidst a wide variety of significant and varied political forces.

ORGANIZATION AND NEW FEATURES OF THE FOURTH EDITION

The book begins with a Prologue that presents six articles from the business and popular press about the incredibly controversial financial reporting issue of whether stock-based compensation should be reported on the issuer's income statement as an expense. Through the articles, the reader can see the issue emerge, attract attention from regulators, create controversy, and then receive an authoritative resolution that was forced on the FASB by the heavy opposition leveled against it. 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 establishes a foundation for the rest of the book by providing a macro-level explanation of why financial accounting is important for the efficiency of the capital markets and the overall economy. In addition, it describes why useful financial information is important to the noninvesting public. 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 closes by considering 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 the intervening 25 years. The previous edition added a new section about potentially negative changes in the composition of the board of trustees that had given corporate accountants a strong measure of influence over the FASB in the early 1990s. This edition describes how that threat to the Board's independence was dramatically turned aside in 1996 through a precedent-setting intervention by the chairman of the Securities and Exchange Commission. In prior editions, this chapter has proven to be especially interesting because of the information that it provides about the people of the FASB. As before, we have not simply described positions in an organization chart but have provided little-known facts about the personalities 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 1996 and the chair who was appointed in 1997. We have continued our description of the often-neglected Research and Technical Activities staff that 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 how the FASB uses its due process to search for the right questions and answers. Because we are relatively unhindered by space limitations, we are able to go beyond other published descriptions of these activities. We believe that readers have been surprised to learn that the system's flexibility allows it to adapt to changes in the environment and the unique factors surrounding each project. We also show that it makes a great deal of political sense to have a due process that includes all constituents. The chapter includes a full description of the hierarchy of authoritative sources of GAAP created in Statement of Auditing Standards No. 69 in 1991. It has been revised to use the stock-based compensation project to illustrate each of the stages in the process, with a special emphasis on the political maneuvering that finally drove the Board to a far weaker standard than its members wanted to issue. The chapter also includes six complete and unedited comment letters that show the reader the types of arguments that constituents provide to the Board, as well as giving them a taste of the bitterness that 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 project, although the stock-based compensation project may have caused it to lose its dubious honor as the FASB's most 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 especially pivotal and politicized recognition and measurement phase of the project. His position on the staff team

gave him special insights into the conceptual issues as well as the personal and political pressures that significantly affected the project's final outcome. 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.

The chapter has been revised for the fourth edition in several ways. First, it now casts the conceptual framework as a vision statement in which the FASB proclaimed the direction that it wanted to take financial reporting. Second, it criticizes the accounting profession for so strongly resisting any movement in the new direction that the Board would have taken accounting practice. Third, readers should be able to understand the concepts statements more easily through new diagrams added to clarify the interrelationships among various parts of the framework. Fourth, the discussion of costs and benefits includes a new point that stockholders both bear the costs and reap the benefits of financial reporting. Thus, preparers' cost-based arguments against new standards are almost certainly misdirected. This edition also has new discussions of comprehensive income and the significant position paper on financial reporting published in 1993 by the Association for Investment Management and Research, which is the largest user constituency representative body. The chapter closes with a brief discussion of the Board's initial efforts to draft a new concepts statement on present-value measurement.

Chapter 5 describes a series of major accounting issues that have attracted the attention of the FASB and its predecessors over the last 50 years. Some recurring issues must be resolved again when they take on new forms in different transactions and industries; others have reappeared simply because of 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, the chapter clearly shows that the standards-setting process is and has always been more political than logical. The fourth edition includes several changes, including the introduction of a new perspective on financial reporting that questions the basic assumption that the information in the financial statements is all that matters. It also presents a more complete description of the effects of setting up an unconsolidated finance subsidiary to achieve off-balance-sheet financing. Readers will also be interested in the new candid criticisms of the Board and its constituents in dealing with the stock-based compensation controversy. Essentially all of the participants came out of this process with less integrity and respectability than they had going into it.

We always enjoy the process of revising Chapter 6, which focuses on the FASB's future and its ability to continue fulfilling its mission. More so than any other chapter, this one candidly describes and assesses the political factors and actors that affect the FASB. The contents include the issues of whether standards setting should take place in the public or private sector, whether standards overload exists, whether international accounting standards are useful, and whether the Board is dominated by financial statement preparers.

There are several important new features for the fourth edition. The first is a specific criticism of intervention in the FASB's due process by members of Congress that accomplishes little more than revealing how uninformed they really are. Although the chapter still describes standards overload, we now believe that the Board has gone too far the other way and is not moving quickly enough to accomplish needed reforms. The discussion of international accounting standards and issues now criticizes the International Accounting Standards Committee for its efforts to supplant U.S. GAAP with more flexible rules and guidelines. We also describe the detrimental effects on U.S. capital markets that would occur if the SEC were to succumb to political pressure from the New York Stock Exchange and others to allow foreign companies into U.S. markets with financial statements that do not comply with U.S. GAAP. This edition also greatly expands its analysis and criticism of the efforts by the leaders of the preparer community to weaken the FASB's ability to accomplish reform.

Another new section in the chapter provides explicit documentation of what we consider to be improper efforts by two trustees to interfere in the Board's due process, despite a prohibition against this activity in the Foundations' bylaws. Finally, we direct special attention to the FEI's 1996 proposals to strip the FASB of many of its powers. Within six months, this blunder by that organization's leaders unwittingly led to significant strengthening of the Board's independence through the drastic modification of the composition of the Financial Accounting Foundation's board of trustees through the tenacity of SEC Chairman Arthur Levitt. This section provides previously unpublished details about the correspondence that flowed between Levitt, Michael Cook (the chairman of the trustees), and Norman Roy, president of the Financial Executives Institute. Although some readers may disagree with our analysis and characterizations of the events and the individuals, we are content to let the facts speak.

WHO SHOULD USE THIS BOOK?

Our original concept for the first edition was to target this book 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, we present 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. We are particularly pleased that many new FASB employees and Board members read the book when they prepare for their new responsibilities. We have also found that many journalists who cover financial reporting issues have read this book to understand more about 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 public or private accountants. It should also be read by others, especially 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 the Board produces.

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In expressing appreciation for the efforts of others, we need to begin with the many people of the FASB who once again helped us gather data we needed. At the top of our list, for her long-suffering patience, friendship, promptness, encouragement, and cheerful cooperation, is Debbie Harrington, the Board's public relations counsel. Of course, we express great thanks to the former chairman of the Board, Denny Beresford, for his encouragement and cooperation. We also thank the new chairman, Ed Jenkins, for his time and assistance at a very busy point in his life. We are similarly indebted to the other six members who were serving in 1997 (Joe Anania, Tony Cope, Neel Foster, Jim Leisenring, Gaylen Larson, and Gerry Mueller), each of whom graciously tolerated our questions while giving us some of their time and insights into their personal lives. The same appreciation is expressed to Tim Lucas, director of Research and Technical Activities, and other staff members, including Julie Ehrhardt, Liz Fender, Brad Harris, Todd Johnson, Sue Marsicek, and Diana Willis.

In order to ensure that there is no misunderstanding, we are responsible for the positions on the controversial issues that are expressed throughout this book. The FASB's cooperation with us must not be interpreted as its endorsement of any of the views we express in the following pages.

Thanks also to our professional colleagues who responded to a survey about the third edition: Earl Littrell at Willamette University, Mike Masoner at Southern Illinois University in Carbondale, Linda Nichols at Texas Tech University, Blaine Ritts of Bowling Green State University, Juan Rivera at the University of Notre Dame, Brian Shapiro at Arizona State University, Howard Shapiro at Eastern Washington University, Charles G. Snow at Rhode Island College, Ed Swanson at Texas A & M University, and David Ziebart at the University of Illinois. Their comments provided invaluable direction and, importantly, great encouragement to keep doing what we have been doing with this book over the last dozen years.

We also wish to thank our many colleagues who have used this book in their classrooms and research to advance our goal of a more informed and a more reform-minded profession. Special thanks go as well to those outside of the academy who have read and gained from this book.

In closing, we want to express our appreciation to Mary Jo Schraml, a recent graduate of the MBA program at the University of Colorado at Colorado Springs, for her capable assistance in adding to the reading lists 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 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 stock-based compensation project that created new practices and disclosures for stock options when the Board issued Statement of Financial Accounting Standards No. 123 in 1995. While going through this prologue, the reader should learn the following points:

- While some standard-setting issues involve accounting for new events and transactions, others, like those in the stock-based compensation 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 this project was whether companies should report an expense when stock options are issued to employees. Under prior accounting rules, the expense treatment was typically avoided. The lack of income statement recognition for the cost of issuing stock options led many individuals and several influential groups including the Accounting Standards Executive Committee, a rule-making body of the American Institute of Certified Public Accountants (AICPA), to conclude that new rules were necessary.
- The federal Securities and Exchange Commission (SEC), the agency with statutory authority to establish accounting rules for public companies, did not provide the new rules. Instead, the SEC looked to another institution within the accounting profession for the needed guidance.

- The Financial Accounting Standards Board (FASB) took on 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. This project was actually on the FASB's agenda twice. The first time began in 1984 and ended in 1988. It was returned to the agenda in 1992. Altogether, 11 years passed between the first date and the issuance of the standard.
- As FASB's tentative position was revealed in its deliberations, it became clear that other groups within the financial reporting community had different positions on how stock options should be accounted for. The groups included management, investors, creditors, investment analysts, independent auditors, and government regulators.
- The strongly stated views expressed by members of these groups reveal that they believe that accounting rules and changes in them are important. Of course, this belief does not prove that financial accounting numbers actually affect decisions, but it does show that people care about the information in the financial statements. Because the numbers are thought to be important, it follows that issues concerning them are also important and often controversial.
- This project illustrates the kinds of influence that constituent groups bring to bear on the FASB to influence the Standard. Most often the influence is direct, as expressed through comment letters and testimony at public hearings. In several instances over the years, and especially for the stock-based compensation project, some of the affected people have gone outside the usual boundaries of the process by bringing the issue to the attention of Congress. Although the threat of congressional action to overturn a proposed FASB decision is indirect and often ineffective, it proved to be highly powerful in this project.
- The reporters from the business press called on people from many different occupations for their views on the issues. The articles quote specific comments from representatives of corporate and investment trade groups, partners of public accounting firms, the chief accountant of the SEC, the president of the AICPA, a member of Congress, and the chair of FASB. Typically, only the FASB's staff speaks to the business press, but because of the great controversy surrounding this project, the chairman took on a more active role with the press.