Development of the Institutional Structure of Financial Accounting

Learning Objectives

After reading this chapter, you should be able to:

- Understand the historical background and development of accounting standard setting in the United States.
- Understand how the Financial Accounting Standards Board (FASB) differs from its two predecessors.
- Understand the institutional problems facing the FASB.
- Appreciate the complexity of the standard-setting process.
- Understand how the liability crisis in public accounting is being modified.
- Grasp the significance of the Sarbanes-Oxley bill and other current developments in accounting.

In Chapter 1, we described the role of accounting theory in the standard-setting process. In this chapter, we focus on major events that have led to the present institutional arrangements for the development of accounting standards in the United States. In Chapter 10, we will briefly examine the standard-setting process in other English-speaking countries as well as attempts to establish uniform accounting standards on an international basis.

In the United States prior to 1930, accounting was largely unregulated. The accounting practices and procedures used by a firm were generally considered confidential. Thus, one
The firm had little knowledge about the procedures followed by other companies. Obviously, the result was a considerable lack of uniformity in accounting practices among companies, both from year to year and within the same industry. Bankers and other creditors, who were the primary users of financial reports, provided the only real direction in accounting practices. Bank and creditor pressure was aimed primarily at the disclosure of cash and near-cash resources that could be used for repayment of debt.

The emphasis on debt-paying ability can be traced back to the social and economic conditions in the United States prior to the end of World War I. The American public typically did not invest large sums in the corporate sector until the 1920s. When the federal government made lump-sum payments for the retirement of Liberty Bonds, the public suddenly had large amounts of available cash. Private corporations were expanding, and both they and government leaders encouraged the public to invest in American business. A “people’s capitalism” concept took hold, and the number of individual shareholder investors rapidly increased. Unfortunately, financial reporting lagged behind investor needs, so reports continued to be prepared primarily for the needs of creditors.¹

Not until the stock market crash of 1929 did shareholder investors begin to question whether accounting and reporting practices were adequate to assess investments. The realization that financial reports were based on widely varying accounting practices and were frequently misleading to current and prospective investors led to the first of three distinct periods in the development of accounting standards:

- The formative years (1930–1946)
- The postwar period (1946–1959)
- The modern period (1959–present)²

Before investigating these three periods, we will briefly survey the development of accounting in the United States prior to 1930.

**Accounting in the United States Prior to 1930**

By the 1880s, it had become clear that accounting was an important instrument in America for conducting business.³ An organization calling itself the American Association of Public Accountants was formed in 1886 with 10 members. In 1896, this organization plus another group—The Institute of Bookkeepers and Accountants—were both behind the successful passage in New York State of the law that created the professional designation of “Certified Public Accountant.” By 1913, 31 states had passed laws providing for the issuance of Certified Public Accountant (CPA) certificates. However, there was little uniformity among the various states regarding the requirements needed to earn the CPA.

Another significant accomplishment of the association was the founding of the *Journal of Accountancy* in 1905. This publication continues to be an important professional journal to the present day.

The early work of the association also included the appointment of a committee on terminology, which resulted in a list of terms and definitions that was adopted in 1915. More terms were defined in various issues of the *Journal of Accountancy*, resulting in the 1931 publication of a 126-page book containing the definitions.
A huge boon to the growing accounting profession was Congress’s enactment of the income tax law in 1913. Another impetus to the profession occurred in 1917 with the entry of the United States into World War I. The specific issue involving public accounting was military contracts in which manufacturers were to be reimbursed on a cost-plus basis.

The American Institute of Accountants (AIA) was formed in 1916 from the old American Association of Public Accountants (the name was changed to the American Institute of Certified Public Accountants [AICPA] in 1957). The new group became a national organization. Its creation was not intended to replace state societies but rather to complement them. It sought to increase uniformity and standardization in qualifications and requirements for membership.

Meanwhile, a second organization—the American Society of Certified Public Accountants—formed in 1921. Whereas the AIA took a unified national outlook relative to issues such as examinations and qualifications, the American Society was more concerned with maintaining power in the various states. Rivalry between these two organizations was very heated. Largely by pressure from the New York State Society, the two organizations combined in 1936, maintaining the name of the older group.

During the rivalry between these two organizations, the AIA was the clear leader in the area of promulgating technical materials. As far back as 1918, the institute, in cooperation with the Federal Trade Commission (FTC), published a pamphlet entitled “Approved Methods for the Preparation of Balance Sheet Statements.” The document was published in the Federal Reserve Bulletin and was considered by that body to provide the minimum standards for conducting a balance sheet audit. The pamphlet was later revised in 1929 under the general direction of the Federal Reserve Board. The document dealt mainly with auditing procedures, but financial accounting matters were, of necessity, discussed.

Another factor leading to an increased demand for auditing services as well as significant questions about the practice of accounting was the onset of the Great Depression in 1929. Questions arose as to whether accounting practices led to poor investment decisions by business, but the case has never been proven. However, the Depression and the election of Franklin D. Roosevelt to the presidency in 1932 and the enactment of the New Deal legislation led to enormous changes in accounting, producing the first of the three distinct periods in the development of accounting standards.

Formative Years, 1930–1946

As a result of the stock market crash, the period from 1930 to 1946 influenced accounting practices in the United States extensively.

NYSE/AICPA Agreement

In 1930, the AICPA (we will use this acronym even though the name was not changed until 1957) began a cooperative effort with the New York Stock Exchange (NYSE) that eventually led to the preparation of one of the most important documents in the development of accounting rule making. The AICPA’s Special Committee on Cooperation with the Stock Exchange worked closely with the NYSE’s Committee on Stock List to develop accounting principles to be followed by all companies listed on the exchange. The NYSE was concerned that listed companies were using a large variety of undisclosed accounting practices. Initially,
the AICPA thought that the best solution was a dual approach: (a) education of users of accounting reports regarding the reports’ limitations and (b) improvement of reports to make them more informative to users. Ultimately, the AICPA’s committee suggested the following general solution to the NYSE committee:

The more practical alternative would be to leave every corporation free to choose its own methods of accounting within... very broad limits..., but require disclosure of the methods employed and consistency in their application from year to year. . . . Within quite wide limits, it is relatively unimportant to the investor which precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year. . . .

The AICPA’s committee prepared a formal draft of “five broad accounting principles” that was approved by the NYSE’s committee on September 22, 1932. This document represented the first formal attempt to develop “generally accepted accounting principles” (GAAP). In fact, the AICPA’s committee coined the phrase “accepted principles of accounting.” The first five principles were later incorporated as Chapter 1 of Accounting Research Bulletin (ARB) 43. The joint effort of the NYSE and AICPA had a profound influence on accounting policy making in the United States during the next 50 years. Reed K. Storey described it this way:

The recommendations [all aspects of the original NYSE/AICPA document] were not fully implemented, but the basic concept which permitted each corporation to choose those methods and procedures which were most appropriate for its own financial statements within the basic framework of “accepted accounting principles” became the focal point of the development of principles in the United States.7

**Formation of the SEC**

Congress created the Securities and Exchange Commission (SEC) in 1934. The SEC’s defined purpose was (and still is) to administer the Securities Act of 1933 and the Securities and Exchange Act of 1934. The two acts were the first national securities legislation in the United States. The 1933 act regulates the issuance of securities in interstate markets; the 1934 act is primarily concerned with the trading of securities. The 1933 and 1934 acts conferred on the SEC both broad and specific authority to prescribe the form and content of financial information filed with the SEC.

The SEC initially allowed the accounting profession to set accounting principles without interference. However, statements made by the SEC in 1937 and 1938 indicated that it was growing impatient with the profession. In December 1937, SEC commissioner Robert Healy addressed the American Accounting Association (AAA): “It seems to me, that one great difficulty has been that there has been no body which had the authority to fix and maintain standards [of accounting]. I believe that such a body now exists in the Securities and Exchange Commission.”8

Finally, on April 25, 1938, the message the SEC was sending the profession became quite clear. The SEC issued Accounting Series Release (ASR) No. 4, which said:

In cases where financial statements filed with the Commission . . . are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial
statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant.\textsuperscript{9}

The implicit message was that unless the profession established an authoritative body for the development of accounting standards, the SEC would determine acceptable accounting practices and mandate methods to be employed in reports filed with it.

**Committee on Accounting Procedure, 1936–1946**

In 1933, the AICPA formed the Special Committee on Development of Accounting Principles, but this committee accomplished very little and was subsequently replaced by the Committee on Accounting Procedures (CAP) in 1936, which also was relatively inactive until 1938. However, in 1938, prompted primarily by the SEC’s new policy embodied in ASR 4, the CAP was expanded from 7 to 21 members and became much more active.

The CAP originally wanted to develop a comprehensive statement of accounting principles that would serve as a general guide to the solution of specific practical problems. However, most felt it would take at least five years to develop such a statement and by that time the SEC undoubtedly would have lost its patience. Thus, the CAP decided to adopt a policy of attacking specific problems and, whenever possible, recommending preferred methods of accounting.\textsuperscript{10}

The CAP, acting in response to ASR 4, began in 1939 to issue statements on accounting principles that, prima facie, had “substantial authoritative support.” During the two-year period of 1938 to 1939, it issued 12 Accounting Research Bulletins (ARBs). The CAP was cognizant of the SEC looking over its shoulder and frequently consulted with the SEC to determine whether proposed ARBs would be acceptable to the commission.\textsuperscript{11}

The SEC was initially satisfied with the accounting profession’s efforts to establish accounting principles. However, it had always let it be known that it was prepared to take over the rule-making process if the profession lagged. The following quotation from the commission’s 1939 report to Congress clearly indicates its position:

> One of the most important functions of the Commission is to maintain and improve the standards of accounting practices. . . . the independence of the public accountant must be preserved and strengthened and standards of thoroughness and accuracy protected. I [Chairman Jerome N. Frank] understand that certain groups in the profession [CAP] are moving ahead in good stride. They will get all the help we can give them so long as they conscientiously attempt that task. That’s definite. But if we find that they are unwilling or unable . . . to do the job thoroughly, we won’t hesitate to step in to the full extent of our statutory powers.\textsuperscript{12}

Not all accounting constituents were happy with the way accounting rules were being developed during this period. Members of the American Accounting Association (AAA)
favored a deductive approach to the formulation of accounting rules—as opposed to the predominantly informal inductive approach employed by the CAP. Regarding the first four ARBs, the editor of The Accounting Review wrote:

It is unfortunate that the four pamphlets thus far published give no evidence of extensive research or of well-reasoned conclusions. They reflect, on the other hand, a hasty marshaling of facts and opinions, and the derivation of temporizing rules to which it is doubtless hoped that a professional majority will subscribe. As models of approach in a field already heavily burdened with expedients and dogmatism, they leave much to be desired.13

This formative era did not produce a comprehensive set of accounting principles. However, it did make two very important contributions. First, accounting practices, especially in terms of uniformity, improved significantly. Second, the private sector was firmly established as the source for accounting policy making in the United States.14 When World War II began, the development of accounting rules slowed down significantly. During the war years, the CAP dealt almost exclusively with accounting problems involving war transactions. Of the 13 ARBs issued between January 1942 and September 1946, 7 dealt with war-related problems and 3 with terminology.

**Postwar Period, 1946–1959**

An even greater economic boom occurred in the postwar period than in the 1920s. Industry required massive amounts of capital in order to expand. The expansion, in turn, created more jobs and more money in the economy. At the encouragement of stock exchanges, industry began to actively tap money available from the public. In 1940, there were an estimated 4 million stockholders in the United States. By 1952, the number had grown to 7 million; by 1962, the number reached 17 million. Thus, a large portion of the American public had a direct financial interest in listed corporations.

Corporate financial reports were an important source of information for financial decisions. Thus, financial reports and the accounting rules used to prepare them received wide attention. For the first time, accounting policy making became an important topic in the financial press. The primary problem was one of uniformity or comparability of reported earnings among different companies. The financial press and the SEC brought increasingly heavy pressure to bear on the accounting profession to eliminate different methods of accounting for similar transactions that significantly affected reported net income.

**ARB 32 and the SEC**

The CAP was busy during the postwar period. In total, 18 ARBs were issued from 1946 to 1953. Although the committee had been quite successful in eliminating many questionable accounting practices of the 1930s, the strategy created a new set of problems during the late 1940s and early 1950s. While eliminating suspect accounting practices, the CAP failed to
make positive recommendations for general accounting principles. As a result, there was an oversupply of “good” accounting principles. Many alternative practices continued to flourish because there was no underlying accounting theory. This situation led to conflicts between the CAP and the SEC.

The most publicized conflict dealt with the all-inclusive income statement versus current operating performance. The CAP felt that utilizing current operating performance would enhance comparability of earnings reports among companies and among years for the same company. Any extraordinary gains and losses, it pointed out, are excluded from net income under the current operating performance concept. Consequently, it issued ARB 32 recommending that concept. Upon issuance of ARB 32, the SEC chief accountant wrote: “The Commission has authorized the staff to take exception to financial statements, which appear to be misleading, even though they reflect the application of ARB 32.”

In 1950, in an amendment to Regulation S-X, the SEC proposed use of the all-inclusive concept. This proposal was in direct conflict with ARB 32. Subsequently, the CAP and the SEC reached a compromise agreement regarding ARB 32 in which extraordinary items (called special items) would be the last items on the income statement. Thus, the CAP maintained its prominent role in policy making. However, it was definitely subject to oversight by the SEC.

The Price-Level Problem

By the end of 1953, the accounting profession became increasingly concerned with accounting under conditions of changing price levels. The profession turned its attention almost entirely to this problem. As a result, for approximately three years little, if any, progress was made regarding the development of accounting principles. The main thrust of the price-level debate dealt with depreciation charges. Depreciation charges based on historical costs did not accurately measure the attrition of fixed-asset values in terms of current purchasing power. The result was an overstatement of reported net income. In general, the profession finally decided that to reflect changes in purchasing power would confuse users of financial statements. As a result, it shelved the price-level debate for many years and directed its attention again to the development of standards of financial accounting.

Closing Years of the CAP

The years from 1957 to 1959 represented a period of transition in the development of accounting standards in the United States. Criticism of the CAP increased, and even pillars of the accounting establishment were disapproving of its operations. Finally, a president of the AICPA, Alvin R. Jennings, called for a new approach to the development of accounting principles.

During the middle and late 1950s, interest in the development of accounting principles was growing both within and outside the profession. Unfortunately, much of this interest took the form of negative criticism directed toward the CAP. Financial executives and accounting practitioners in the smaller firms complained that they were not given an adequate hearing
to express their opinions on proposed ARBs. Many felt that the CAP worked too slowly on pressing issues and refused to take unpopular positions on controversial topics. Leonard Spacek, managing partner of Arthur Andersen & Co., shocked the accounting profession with these remarks:

The partners of our firm believe that the public accounting profession is not in important respects carrying its public responsibility in the certification of financial statements at the present time. We believe that the profession’s existence is in peril. Until the profession establishes within its framework (a) the premise of an accepted accounting principle, (b) the principles of accounting that meet those premises, and (c) a public forum through which such principles of accounting may be determined, our firm is dedicated to airing in public the major shortcomings of the profession.17

Spacek seemed to be calling for the profession to prepare a comprehensive statement of basic accounting principles. In this he was not alone. In 1957, the AAA had published a statement of underlying concepts and definitions in which it at least attempted a deductive approach.18 From its very inception, the CAP had discarded a formalized deductive approach because it was too time consuming. In fact, the committee had devoted its time to solving specific problems by prescribing rules on a piecemeal basis—without developing fundamental principles of financial accounting, much less a comprehensive theory.

A New Approach

Alvin R. Jennings delivered a historic speech in 1957 at the AICPA’s annual meeting. He suggested a reorganization of the AICPA to expedite development of accounting principles. Jennings emphasized the need for research as part of this process. In other words, he called for a conceptual approach to replace the piecemeal method that had been followed for 20 years by the CAP. The accounting profession was ready to consider Jennings’s new approach. The AICPA appointed a Special Committee on Research Program, which finished its report in less than a year. This report became the “articles of incorporation” for the Accounting Principles Board (APB) and the Accounting Research Division. The report emphasized the importance of research in establishing financial accounting standards:

Adequate accounting research is necessary in all of the foregoing [establishing standards]. Pronouncements on accounting matters should be based on thorough-going independent study of the matters in question, during which consideration is given to all points of view. For this an adequate staff is necessary. . . . Research reports or studies should be carefully reasoned and fully documented. They should have wide exposure to both the profession and the public.19

The CAP was heavily criticized, perhaps deservedly so, but it represented the profession’s first sustained attempt to develop workable financial accounting rules. It issued a total of 51 ARBs during its existence. One of these, ARB Opinion No. 43, represented a restatement and revision of the first 42 bulletins. Significant parts of ARB Opinion 43 remain in force to this day. Throughout the CAP’s life, ARBs were increasingly recognized as authoritative and had a pronounced effect on accounting practice.
Modern Period, 1959 to the Present

The “charter” that created the APB and the Accounting Research Division called for a two-pronged approach to the development of accounting principles. The research division was to be semiautonomous. It had its own director, who had authority to publish the findings of the research staff, and was to be exclusively devoted to the development of accounting principles with no responsibilities to the technical committees of the AICPA. In establishing what research projects to undertake, the director of research had to confer with the chairman of the APB. If the two disagreed, the APB as a whole determined which projects the research division would undertake. Results of the projects of the research division would be published in the form of Accounting Research Studies (ARSs). These studies would present detailed documentation, all aspects of particular problems, and recommendations or conclusions. At the outset, two projects were called for in the special committee’s report: (1) the “basic postulates of accounting” and (2) a “fairly broad set of coordinated accounting principles” based on the postulates.

In form, the APB was very similar to the CAP. It had from 18 to 21 members, all of whom were members of the AICPA. They represented large and small CPA firms, academe, and private industry. The hope was that the APB’s opinions would be based on the studies of the research division. A two-thirds majority was required for the issuance of an opinion, and disclaimers of dissenting members were to be published.

Early Years of the APB

The early years of the APB were characterized by failure and doubt. Research studies called for in the original charter were not accepted by the profession, and controversy surrounding the investment tax credit resulted in a serious challenge by large CPA firms to the board’s authority.

ARSs 1 and 3

ARS 1, The Basic Postulates of Accounting, by Maurice Moonitz, published in 1961, did not initially generate much reaction, favorable or unfavorable, from either the APB or the profession. Apparently, everyone was awaiting the publication of the companion study on principles before passing judgment. ARS 3, A Tentative Set of Broad Accounting Principles for Business Enterprises, by Robert Sprouse and Moonitz, appeared in April 1962. To say the least, this study provoked criticism from all areas. In fact, following the publication of the text of the study, 9 of the 12 members of the project advisory committees on the postulates and principles studies issued personal comments. Only one of the comments was positive. APB Statement 1 expressed the APB’s views of the study. The statement said, in part: “The Board believes, however, that while these studies [1 and 3] are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time.”

By issuing that statement, the APB seriously weakened the dual approach to the development of accounting standards.
In November 1962, the issuance of APB Opinion No. 2, which dealt with the investment tax credit, caused another problem. The profession as a whole was divided on how to account for the investment tax credit. Two alternatives existed: (1) recognizing the tax benefit in the year received, designated the flow-through method, and (2) recognizing the tax benefit over the life of the related asset, called the deferral method. The board chose not to commission a research study on the subject and issued APB Opinion No. 2, which opted for the deferral method. Almost immediately, three large CPA firms made it known that they would not require their clients to follow the opinion. Furthermore, in January 1963, the SEC issued ASR 96, which allowed registrants to employ either the flow-through or deferral methods. Obviously, these large CPA firms and the SEC had challenged the APB’s authority. As a result, APB Opinion No. 4 was issued, which permitted the use of either method.

This successful challenge caused the binding authority of APB opinions to be questioned in the press for several years. Finally, in late 1964 the AICPA’s council (the organization’s governing body) declared the authority of APB opinions in an appendix to APB Opinion No. 6. It unanimously agreed that departures from APB opinions must be disclosed in financial statements audited by a member of the AICPA. If the independent accountant concluded that a method being employed had substantial authoritative support, even though it was not contained in a specific accounting principle, this support must be disclosed in footnotes or the auditor’s report. Furthermore, the auditor must, if possible, disclose the effect of the departure. If the principle employed did not have substantial authoritative support, the auditor must qualify the opinion, give an adverse opinion, or disclaim the opinion. Thus, as 1964 drew to a close, the authoritative nature of APB opinions had been established. However, the two-pronged approach to the development of accounting principles had yet to be implemented.

The Embattled APB

From 1965 to 1967, further criticisms of the board appeared in the press. The “high-profile” period for the accounting profession had arrived. The diversity of accounting practices was discussed in Barron’s, Business Week, Dun’s Review, Forbes, Fortune, the New York Times, and the Wall Street Journal. Despite the public controversy, the APB compiled an impressive list of accomplishments.

During this period, the APB issued seven opinions, including at least three that were noteworthy. Accounting for the employer’s cost of pension plans successfully utilized the desired approach embodied in the charter. ARS 8, Accounting for the Cost of Pension Plans, by Ernest L. Hicks, reviewed the arguments for and against various accounting alternatives and the practical problems of each. APB Opinion No. 8 used this research study as a source document. Not only did APB Opinion No. 8 represent the first real application of the two-pronged approach, but it also received unanimous approval from the board.

Also adopted unanimously by the board was APB Opinion No. 9, which dealt with the areas of extraordinary items and earnings per share. This opinion eliminated the wide diversity in existing practices for handling extraordinary items. Also, it approved the all-inclusive concept of the income statement.
In another controversial area, income tax allocation, the dual approach was again employed. ARS 9, *Interperiod Allocation of Corporate Income Taxes*, by Homer Black, was used as a source of information in the deliberations of the board. Although controversial, APB Opinion No. 11, which required comprehensive income tax allocation, did significantly curtail alternative procedures in practice. Thus, by the close of 1967, the board had finally demonstrated it could function in a meaningful manner.

**ARS 7 and APB Statement 4**

When the accounting profession failed to accept ARS 1 and ARS 3, another research study was commissioned. Its objectives were to discuss the basic concepts of accounting principles and summarize existing acceptable principles and practices. For this purpose, ARS 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*, by Paul Grady, was successful. Although the study was well received by the profession, it fell short of the original task assigned to the board in 1958 by the Special Committee on Research Program. Grady codified existing pronouncements (over 50% of the study was reproductions of pronouncements) and then tried to derive the profession’s existing structure of principles. The study blended inductive and deductive approaches because it took existing pronouncements and then attempted to deduce accounting principles from the body of accepted pronouncements.

Possibly because of the failure of the APB to accomplish its original task on accounting principles, the Special Committee of the Accounting Principles Board recommended that “at the earliest possible time” the board should set forth the purposes and limitations of financial statements, determine acceptable accounting principles, and define “generally accepted accounting principles.”

To accomplish this task, a committee worked for five years to produce APB Statement 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, which was approved by the APB in 1970. The statement had two purposes:

1. to provide a foundation for evaluating present accounting practices, for assisting in solving accounting problems, and for guiding the future development of financial accounting; and
2. to enhance understanding of the purposes of financial accounting, the nature of the process and the forces which shape it, and the potential and limitations of financial statements in providing needed information.

APB Statement 4 covered many of the same topics included in ARS 7, but it went beyond that study (as Chapter 6 will show). The statement had no authoritative standing, however. Being an APB *statement*, as opposed to an *opinion*, “it is binding on no one for any purpose whatsoever.” Thus, the APB failed in its original charge to set forth the basic postulates and broad principles of accounting, at least in any binding and coherent manner.

**Continuing Criticism**

Criticism of the standard-setting process continued and was dual in nature: (a) exposure for tentative APB opinions was too limited and occurred too late in the process and (b) the problems with business combinations showed the standard-setting process was too long and subject to too many outside pressures that were not appropriately channeled into the formulation process.
In response to considerable criticism of the exposure process, the APB initiated several important changes that have been carried forward to the Financial Accounting Standards Board (FASB). It introduced public hearings in 1971 and circulated discussion memorandums to interested parties several months prior to the drafting of proposed opinions. These memoranda discussed all aspects of the particular accounting problem and invited interested parties to send written comments as well as to voice their views at the public hearing. After the public hearing, outlines of the proposed opinion were distributed to interested parties for “mini-exposure” to determine initial reaction to the proposed opinion. Following that stage, an official exposure draft of the proposed opinion was widely distributed throughout the profession and comments were requested. Ultimately, the opinion required at least a two-thirds favorable vote of the board to be issued. The broadened exposure process prior to issuance of an accounting standard allowed interested parties to be involved in the standard-setting process and tended to alleviate criticism, other than that of timeliness, of the APB.

The controversy over business combinations and goodwill was the most time consuming and extensively discussed problem the APB faced. In 1963, it published ARS 5, *A Critical Study of Accounting for Business Combinations*, by Arthur Wyatt; ARS 10, *Accounting for Goodwill*, by George Catlett and Norman Olson, appeared in the latter part of 1968. Both of these studies reached conclusions that were at variance with existing accounting principles. ARS 5 concluded that pooling-of-interests accounting should be discontinued and that goodwill may have two components—one with limited life requiring periodic amortization, the other with unlimited life to be carried forward indefinitely to future periods. ARS 10 concluded that goodwill does not qualify as an asset and should be immediately subtracted from stockholders’ equity upon completion of the combination.

Business combinations and goodwill received more publicity and discussion than any other subject taken up by the APB. News publications such as *Time* and *Newsweek* had several articles on the subject. Three congressional committees and the Federal Trade Commission (FTC), as well as the SEC, concerned themselves with the merger accounting problem.\(^{25}\)

A brief review of the various drafts of the proposed opinion on business combinations and goodwill indicates the difficulty in establishing accounting principles on this subject. The initial draft opinion, in July 1969, proposed that pooling of interests should be eliminated and goodwill should be amortized over a period no longer than 40 years. In February 1970, another draft opinion allowed pooling of interests when a 3-to-1 size test was met and also required amortization of goodwill over a maximum of 40 years. The APB was unable to obtain a two-thirds majority on the draft. Finally, in June 1970, a two-thirds majority agreed to allow pooling of interests with a 9-to-1 size test and goodwill amortization restricted to the 40-year maximum. However, when the APB met again in July, one member changed his vote. Thus, the board was again at an impasse. Finally, the business combination and goodwill subjects were split into two opinions: APB Opinion No. 16 on business combinations, eliminating the size test for a pooling of interests, passed 12 to 6; APB Opinion No. 17 on goodwill, requiring amortization over a maximum of 40 years, passed 13 to 5.

The difficulty of arriving at definitive standards of accounting for business combinations and goodwill was certainly in part responsible for the decision to begin a comprehensive review of the procedures for establishing accounting principles. In April 1971, the AICPA
formed two special study groups. One group, The Study Group on Establishment of Accounting Principles, was chaired by Francis M. Wheat, a former SEC commissioner and a long-time critic of the accounting profession. The second group, The Study Group on the Objectives of Financial Statements, was chaired by Robert M. Trueblood, a prominent CPA and managing partner of Touche Ross & Co.

**The Wheat and Trueblood Committee Reports**

The Wheat Committee completed its report in March 1972. It called for significant changes in the establishment of financial accounting standards. The report made the following recommendations:

- The establishment of a Financial Accounting Foundation. This foundation would have 9 trustees whose principal duties would be to appoint members of the FASB and raise funds for its operation.
- The establishment of the FASB. The Board would have seven full-time members and would establish standards of financial reporting.
- The establishment of the Financial Accounting Standards Advisory Council. This Council, with 20 members, would consult with the FASB for establishing priorities and task forces as well as reacting to proposed standards.26

The AICPA's council accepted the recommendations in June 1972; the FASB became a reality on July 1, 1973.

The Trueblood Committee (also called the Study Group) did not complete its report until October 1973, after the formation of the FASB. The report identified several objectives of financial statements but did not make any suggestions regarding implementation. It concluded with the following statement:

The Study Group concludes that the objectives developed in this report can be looked upon as attainable in stages within a reasonable time. Selecting the appropriate course of action for gaining acceptance of these objectives is not within the purview of the Study Group. However, the Study Group urges that its conclusions be considered as an initial step in developing objectives important for the ongoing refinement and improvement of accounting standards and practices.27

The FASB subsequently considered the Trueblood Committee’s report in its conceptual framework project.

**The FASB: An Overview**

The charge to the newly formed FASB was different in one important respect from that given to the APB in 1959. Whereas the APB was to work toward standard setting with a two-pronged approach, the new FASB, although it had a research division, was to establish standards of financial accounting and reporting in the most efficient and complete manner possible. Thus, the FASB was not required to stipulate the postulates and principles of accounting as an underlying framework. Perhaps a trade-off between “efficiency” and “completeness” was intended. Ironically, FASB Statements are more thoroughly researched than prior standards of either the
CAP or the APB. The FASB also launched the conceptual framework project, a major attempt to provide a "constitution" for the standard-setting function.

**Mechanics of Operations**

The structure for establishing financial accounting standards has been modified somewhat since the FASB’s founding in 1973. The modifications were the result of recommendations made by the Structure Committee of the Financial Accounting Foundation (FAF) in 1977. Exhibit 3.1 diagrams the organizational structure and its relationship to its constituency.

The FAF’s Board of Trustees consists of 16 members, 11 members nominated by eight organizations: the AAA, AICPA, CFA Institute, Financial Executives International (FEI), Government Finance Officers Association, Institute of Management Accountants (IMA), Securities Industry Association, and National Association of State Auditors, Comptrollers and Treasurers. An additional five members come from at-large nominations. The Trustees approve all member additions and are responsible for oversight, administration, and finances of the FASB and the Governmental Accounting Standards Board (GASB).

The FASB includes seven members, each serving five-year terms. Any individual member can serve a maximum of two terms. During their terms of office, board members must maintain complete independence. This applies not only to other employment arrangements (past, present, or future) but also to investments. “There must be no conflict, real or apparent, between the members’ private interest and the public interest.” The background requirement for board members is simply knowledge of accounting, finance, and business and concern for the public interest. In March 1979, for the first time the Board had a majority of members with backgrounds primarily in areas other than public accounting.

The Financial Accounting Standards Advisory Council (FASAC) is instrumental in the establishment of financial accounting standards. It is also appointed by the Board of Trustees. The FASAC advises the FASB on its operating and project plans, agenda and priorities, and appointment of task forces, as well as on all major or technical issues.

The standard-setting procedure starts with the identification of a problem. A task force is then formed to explore all aspects of the problem. It produces a discussion memorandum identifying all issues and possible solutions, which is widely circulated to interested parties. The FASB then convenes a public hearing during which interested parties may make their views known to the Board. Subsequently, an exposure draft of the final standard is issued and written comments are requested. After consideration of written comments, either another exposure draft is issued (if significant changes are deemed necessary) or the Board takes a final vote. A normal 4-to-3 majority vote is required for passing new standards.

However, do not assume that the FASB standard-setting procedure is cut-and-dried. Johnson and Swieringa have given an extensively detailed discussion of the process involving SFAS No. 115 on accounting for marketable securities. To say the least, the process was highly political. Adding to the complexity was the intertwining of the marketable securities project with the financial instruments project (marketable securities are a subset of financial instruments). Johnson and Swieringa traced the sequence of events, which went from 1986 through issuance of the standard in 1993 to the issuance of the implementation guide in 1995, a total of 111 events. Putting it further into perspective, the FASB devoted 11,000 staff hours to the...
The FASB and FASAC involved but also the SEC,
the Federal Home Loan Bank Board, and the chairman of the Board of Governors of the Federal
Reserve System, as well as several other government agencies. Among the issues involved
were not only how marketable securities should be accounted for but also the scope of the secur-
ities that would be covered by the standard, and whether financial institutions would be
subject to the standard. Hence, a highly charged political atmosphere surrounded the project.
Kinney made some very trenchant observations about the process involving SFAS No. 115. First, the FASB process developed in the 1970s may not be capable of dealing with the more complex environment of the 1990s and beyond. For example, financial markets are now globalized, communication is virtually instantaneous, deregulation erodes differences between financial institutions making them more competitive, and information technology makes it possible to assess risks of both financial assets and financial liabilities leading to better possibilities of determining current valuations on both sides of the balance sheet. Second, the more complex environment may well have a detrimental effect on the typical financial statements generated under GAAP. For example, some nonfinancial measures may correlate more closely with security prices than financial measures such as income. Third is the issue of how adaptable the conceptual framework (Chapter 7) is to newly emerging types of businesses and business situations and transactions (how this document might be amended and extended may become an important consideration in the relatively near future).

**Assessment of the FASB**

The FASB has been subject to extensive scrutiny over the years. Even though the SEC has allowed the accounting profession to set standards, the fact remains that the SEC has the legal authority to establish standards whenever it chooses. Both the CAP and the APB made important progress in eliminating poor accounting practices and in standardizing existing practices, but they were not successful in developing a theoretical basis for standard setting. In the early years of the FASB’s existence, it too was criticized. Some said it issued too many pronouncements, while others complained that not enough had been issued. Some critics said the Board was too conceptual in its approach, but others said it had ignored research and accounting theory. Furthermore, some felt the FASB did not have a significant effect on financial reporting, although others maintained that changes had been too radical.

With all this in mind, a comprehensive review of the Board was undertaken by the Structure Committee of the Board of Trustees of the FAF in late 1976. The basic charge of the committee was to “make recommendations to the Board of Trustees regarding any changes in the basic structure of the FASB and the FASAC.” The committee’s report included 17 major findings. It found overwhelming support for maintaining the standard-setting process in the private sector and for the FASB as the right body to discharge that responsibility. Regarding the standard-setting process, the committee found that:

1. The process of establishing a new accounting standard requires careful consideration of the views of all elements of the constituency.
2. The process requires research to assess the possible effects of a proposed standard.
3. A successful standard cannot be imposed by the standard setter; it must be assimilated by the constituency.
4. The assimilation process may require an educational effort to demonstrate the overall value of the proposed new standard.
Since 1977, as a result of the various findings of the Structure Committee, significant changes have occurred. Basically, these changes have increased the involvement of the constituency. Meetings of the FASB, FASAC, the Foundation, and task forces are now open to the public. Additionally, the Board publishes a weekly news bulletin, *Action Alert*.\(^{37}\) Furthermore, the Board has made greater use of available resources outside the FASB staff as well as of task forces. As a result, the Board has become sensitive to the potential economic consequences of proposed standards prior to issuance.

The FASB has been quite productive when compared with its predecessors. It has issued more than 159 Statements of Financial Accounting Standards as of June 2007, as well as numerous interpretations and technical bulletins. If a philosophical trend can be inferred from these standards, it would be that there is a move to “clean up the balance sheet.” This has resulted in a more conservative balance sheet with immediate, as opposed to delayed, recognition of events on the income statement. In addition, between 1978 and 1985 the FASB issued six Statements of Financial Accounting Concepts and a seventh in 2000. These statements constitute the *conceptual framework*, a document that is intended to provide a theoretical underpinning for the assessment of accounting standards and practices. (Chapter 7 takes a critical look at the conceptual framework.) Exhibit 3.2 summarizes some areas of difference among the FASB, the APB, and the CAP. The FASB, in our opinion, has been more successful than its two predecessors. Nevertheless, despite its accomplishments, the FASB once again came under severe attack.

**Evolution of FASB’s Power**

Several organizations have attempted to restrict or constrict the FASB’s legislative powers. When responsibility for standard setting was transferred from the AICPA to the FASB in 1972, the AICPA established the Accounting Standards Executive Committee (AcSEC) to perform a liaison function between the AICPA and the FASB. This committee responds to discussion memoranda, invitations to comment, and exposure drafts and prepares issue papers for the FASB that can add a subject to the Board’s agenda.

AcSEC issues two types of pronouncements: Statements of Position (SOP) and Industry Accounting Guides (Guides). Generally, SOPs and Guides deal with more narrow, specialized subjects than FASB Statements.

In Statement of Auditing Standards No. 69 issued in 1992, SOPs and Guides are considered to be just below FASB Statements, APB Opinions, and extant CAP research bulletins in the hierarchy of generally accepted accounting principles (GAAP) for nongovernmental entities.

Unlike FASB Statements, neither the SOPs nor the Guides are considered mandatory accounting standards under the AICPA’s Rule 203 of the Rules of Conduct, but the FASB has embarked on a program (see Statement of Financial Accounting Standards [SFAS] No. 32) to incorporate the majority of the SOPs and Guides in FASB Statements. SOPs, however, are becoming broader in scope and may affect many industries. For example, SOP 92-3, *Accounting for Foreclosed Assets*, affects all reporting entities except those already using current value for foreclosed assets.\(^{38}\) In addition to its pronouncements, AcSEC periodically prepares *Issue Papers* covering various accounting practice problems that frequently cause a
subject to be added to the FASB’s agenda. Among the standards that have come up through
the AcSEC route are SFAS No. 61, *Accounting for Title Plant;* SFAS No. 63, *Financial Reporting
by Broadcasters;* and SFAS No. 65, *Accounting for Certain Mortgage Banking Activities.* AcSEC
work that has not yet become embodied in FASB Standards is designated “preferable
accounting principles” in SFAS Nos. 32 and 83, which justify accounting changes in accordance
with APB Opinion No. 20.

If fairly narrow industry-type standards have become the province of AcSEC, another
group—the Emerging Issues Task Force (EITF)—created in 1984, has concerned itself with
highly technical issues, such as financial instruments, which may affect firms in virtually
every industry. The EITF has also been concerned with specialized problems of financial insti-
tutions. Members of this group consist of senior technical partners of the major firms and the

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**Exhibit 3.2** Comparing the CAP, APB, and FASB

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>CAP</th>
<th>APB</th>
<th>FASB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organizational independence</td>
<td>Part of AICPA</td>
<td>Part of AICPA</td>
<td>Separate from AICPA; six sponsoring organizations</td>
</tr>
<tr>
<td>Independence of members</td>
<td>Other full-time employer</td>
<td>Other full-time employer</td>
<td>Full-time employee of FASB, usually CPA firm</td>
</tr>
<tr>
<td>Breadth of membership</td>
<td>Must be CPA</td>
<td>Must be CPA</td>
<td>Need not be CPA; members have come from public accounting, government, industry, securities firms, academe</td>
</tr>
<tr>
<td>Due process</td>
<td>Little if any</td>
<td>Very limited, although it became broader toward the end of its existence</td>
<td>More extensive and brought into the process (open hearing and replies to exposure draft for example); can lead to problems of “democratic paralysis” (see Chapter 4)</td>
</tr>
<tr>
<td>Theoretical document supporting standards</td>
<td>Not attempted</td>
<td>Postulates and principles failed; neither ARS No. 7 nor APB Statement No. 4 were particularly successful</td>
<td>Conceptual framework completed more successful than APB efforts</td>
</tr>
<tr>
<td>Use of research</td>
<td>Very limited</td>
<td>Main use was in ARSs</td>
<td>More extensive than its predecessors, discussion memorandums search the literature; the FASB has commissioned several research studies</td>
</tr>
</tbody>
</table>
chief accountant of the SEC. The EITF does not have any formal authority, but its consensus views may well be de facto GAAP.39 One fear is that the EITF may establish excessively complicated and complex standards such as those of the Internal Revenue Code, which might result in rule-dominated practice that could erode professionalism.40

A further challenge to the FASB’s standard-setting powers has come from the Government Accounting Standards Board (GASB), created by the FAF in 1984 to deal with municipal accounting. Unfortunately, its responsibilities overlap with those of the FASB, resulting in an old-fashioned turf battle. Separately issued general-purpose financial statements of such entities as hospitals, colleges and universities, and pension plans are supposed to use FASB standards except where the GASB has issued a particular standard covering a specific type of entity or a precise economic practice or activity. As a result of this overlap, GASB standards tend to “muscle out” particular FASB standards for governmental entities. The situation became intolerable for both private and public industries that had previously used FASB standards and preferred to continue to do so. However, some public-sector organizations wanted the dispute settled on the basis of public versus private ownership and threatened to withdraw support of FAF if it was not.41 A tentative compromise has largely agreed to this system. In addition, separately issued general-purpose financial statements of colleges and universities, health care organizations, and gas and electric utilities are to be subject to FASB standards unless governing boards of public-sector organizations in these categories decide to be governed by GASB standards.42

The AcSEC and EITF were established to solve the problems of particular industries as well as to address narrow technical issues; the GASB establishes a different jurisdiction. Two prominent business organizations aimed a much more direct blow at the essence of the way the FASB operates. The FASB, as a separate organization with its own staff and board members, could be neutral in a way that its predecessors could not be. But in July 1985, the Financial Executives International (FEI) and the Accounting Principles Task Force of the Business Roundtable (an organization comprising the chief executive officers of most major American corporations) urged a stronger business representation on the FASB itself and among the trustees of the FAF. The major complaints seemed to be the cost of preparing standards (e.g., SFAS No. 96) and the difficulty of understanding them (e.g., SFAS Nos. 33 and 96). Additional FASB members (one to two members) now come from business under the Board’s present composition, although the business “takeover” attempt appears to have been effectively parried. Nevertheless, the concerns of business may not have fallen on deaf ears. Indeed, in 1990 the FAF changed the vote required to pass a standard from 4-to-3 back to 5-to-2. This may have been a sign of improvement in FASB operations. If a standard can pass by only a 4-3 margin (as has frequently been the case), it may well indicate that part or all of the standard should be carefully reconsidered.43 Nevertheless, in 2002 the FASB once again switched back to a 4-to-3 required margin for passing standards.44

However, make no mistake about it: The FASB has been under strong attack. The pressure was intensified by the FASB’s attempt to attribute an expense to incentive-type stock options, which has, in particular, upset small growth-oriented, high-technology firms. However, the FASB eventually prevailed in this argument with the passage of SFAS Nos. 123 and 123R.
We do not think that the FASB will be meet extinction. However, the SEC has clearly increased its influence by providing the funding. The next step would be a public-sector takeover by the SEC or a body designated by and subservient to the SEC. The FASB will quite likely survive, but the effects of continuing accounting scandals may well limit its independence, morphing it into a quasi-governmental agency.

While not related to these challenges to the FASB, it is worthwhile to note what causes public firms to oppose and lobby against proposed standards. Elbannan and McKinley discuss factors that lead firms to lobby against proposed FASB standards while still operating within the prescribed rules. Their framework is complementary to agency theory studies that stress opposition arising mainly from financial and economic consequences. They posit that standards creating perceived uncertainty in the prediction of future variables and those producing high information processing costs incite the corporate resistance efforts.

**Congressional Investigations**

We have described challenges to the FASB’s legislative authority that have arisen from dissatisfaction with the standard-setting process. Another source of pressure has been the congressional investigation of the auditing profession and the standard-setting apparatus. Two congressional subcommittee reports circulated in late 1976 and early 1977 were highly critical. Congressman John E. Moss was chairman of a subcommittee whose report was particularly critical of the diversity of existing generally accepted accounting principles. The report of the Senate subcommittee, chaired by Senator Lee Metcalf, was directed toward the institutional structure of financial accounting. The report was critical of the concentration of power by the FASB, SEC, AICPA, and the “Big Eight” (now “Big Four”) CPA firms. In essence, the report called for government regulation of the entire profession. Following public hearings, the report was modified significantly to allow standard setting to remain in the private sector.

Many organizational changes have occurred because of these congressional investigations. The principal purpose of these changes has been to:

- strengthen the auditing process and the independence of auditors,
- assure compliance with high standards of performance not only of individual CPAs but also of CPA firms under an effective self-regulatory system,
- assure greater participation by public representatives in the affairs of the profession,
- establish distinctions between public and smaller nonpublic companies for purposes of applying technical standards, and
- enhance the overall effectiveness of the profession in serving public needs.

Furthermore, the SEC must now include a specific section on the accounting profession in its annual report to Congress. In general, since the time of the congressional investigations, these reports have been complimentary to the profession in terms of standard setting and self-governance. The allegation of undue influence over the FASB by the then Big Eight public accounting firms has yet to be substantiated by concrete evidence. Brown’s research did, however, show a similarity of responses by seven of the Big Eight firms to 12 discussion memoranda of the FASB appearing between October 1974 and December 1977.
Such similarity assuredly shows a general agreement on issues, but absolutely nothing more in terms of the possibility of collusion. It is interesting to note that the resulting FASB Statements appeared to be evenly split in terms of “closeness” between the attestors (the then Big Eight firms) and the preparers of financial statements (as evidenced by corporate respondents and interest groups).\textsuperscript{49}

Congress continued to scrutinize the public accounting profession. A subcommittee of the House of Representatives, chaired by Congressman John D. Dingell, was concerned with the laxity of auditors in detecting and disclosing fraud. Because of this concern, the National Commission on Fraudulent Financial Reporting (Treadway Commission) was formed in 1985. Its recommendations were to increase the auditor’s responsibility for detecting fraudulent financial reporting. The resulting Private Securities Litigation Reform Act of 1995 required that the audit include procedures designed to give reasonable assurance that illegal acts that would materially affect financial statements will be detected.\textsuperscript{50}

If illegal acts are detected and they are consequential, the auditors must report this to the audit committee. If corrective action is not taken and the board of directors does not inform the SEC, the auditor should report the situation to the SEC and consider resigning from the engagement.\textsuperscript{51} Liability, however, may still exist for the auditor if the quantity or timeliness of information disclosure is inadequate.

Despite increasing regulation of the auditor’s responsibilities, within CPA firms the importance of the audit function relative to the management consulting function steadily declined throughout the 1990s. As business failures increased, the SEC began questioning whether consulting fees were compromising the auditor’s independence and adversely affecting the public’s interests. The profession strongly resisted. As Shaun O’Malley, retired chairman of the former Price Waterhouse LLP summed it up, “There’s never been a case where an audit failure in any way related to nonaudit services.”\textsuperscript{52} Of course, subsequent corporate accounting scandals and SEC-mandated public disclosure of fees paid to the firm’s auditor showed the potential financial risk to the auditor if it were to say no to its client. The idea that the audit firm has the integrity to stand its ground even though it may be biting the hand that feeds it is admirable. However, in practice, the potential loss of revenues totaling millions of dollars evidently encouraged a rationalization that aggressive, sometimes fraudulent, accounting was not of sufficient materiality to warrant a less than unqualified audit opinion. Following a series of high-profile scandals (e.g., Enron, Arthur Andersen, WorldCom, Tyco), Congress responded with near emergency-like legislation producing one of the most significant reform packages since FDR’s New Deal—the Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act of 2002 (SOX).\textsuperscript{53}

**Sarbanes-Oxley Act (SOX)**

SOX established the Public Company Accounting Oversight Board (PCAOB), a private-sector regulatory body overseen by the SEC. The PCAOB is responsible for registering public accounting firms, setting audit standards, inspecting registered accounting firms, and enforcing compliance with SOX. The AICPA’s Auditing Standards Board (ASB) no longer sets the standards for auditing, attestation, and quality control. The PCAOB must consult with professional groups such as the ASB, but it has full authority to establish the standard as it deems
necessary. SOX replaced peer review with inspection by the PCAOB, another step away from self-management by the profession. These changes prompted the AICPA to rethink its role in this new regulatory structure.

In addition to establishment of the PCAOB, SOX more clearly defined auditor independence, record retention requirements, audit committee roles in corporate governance, CEO and CFO certifications of financial statements, and penalties for noncompliance. This basket of far-reaching regulations was intended to restore public confidence lost in the 1990s and early 2000s owing to financial abuse stemming from major scandals.

The emphasis on short-term profitability led to dysfunctional behaviors by management and an eventual blemish on the accounting profession. In addition to the emphasis on short-term profitability, the audit committees and corporate boards of directors—particularly compensation committees—failed to assert themselves.

On the surface, SOX appears to affect the auditing profession alone; statutory authority for setting financial accounting and reporting standards for publicly held companies remained with the SEC. However, for 30+ years, the SEC had relegated these responsibilities to the FASB, a private sector, independent organization. A subtle but important SOX-related change concerns the FASB budget; the majority of its funding ($20+ million per year) originally came from private-sector contributions. SOX now requires that FASB funding be like PCAOB funding, originating from fee assessments on public companies and accountants, not contributions. The change increases FASB’s independence from the constituents it serves but increases its dependence on the SEC for approval of its budget. For the past two decades, the accounting profession and the government have strongly advocated the importance of the FASB as an independent regulatory body. However, current rhetoric and laws are inconsistent. For better or worse, the FASB lost a significant amount of independence from the SEC with SOX’s passage. Now, the SEC controls the FASB’s funding via the budgetary process. As a result of SOX, the FASB can no longer assess operating fees from corporations and public accountants.

SOX implementation became the immediate focus of public companies and CPA firms. An unrelenting stream of financial restatements and news of corporate malfeasance initially muffled frustrations of actually implementing the new law. Absent guidance on materiality guidelines, arguments arose questioning the cost benefit of Section 404, the requirement that public companies review and assess their internal controls. The compliance costs for small companies raised the question, “Can one size fit all?” The presumed exodus of initial public offerings (IPO) from the U.S. to foreign exchanges was argued to result from the overly burdensome regulatory requirements of SOX. Conversions of public companies to private ownership further bolstered the argument that the law had gone too far. Rather than viewing SOX-related compliance costs as an investment to bring previously underfunded internal controls up-to-date, business clamored to alter the law despite the voices of former prominent regulators, Paul Volcker (chairman of the Federal Reserve, 1979–1987) and Arthur Levitt, Jr. (SEC chairman, 1993–2001). Eventually, regulators yielded to an easing of the rules, rationalizing that monetary savings warranted the revision. Despite the onerous costs presumably brought about by SOX, Thomson Financial finds American securities markets robust relative to initial public offerings by foreign firms.
International Convergence

Currently, a single set of accounting standards does not exist in all capital markets; U.S. GAAP is not universally accepted in all countries. The term “harmonization” was used for many years to reflect this international objective, but “convergence” is the currently accepted term in use. In 2002, the International Accounting Standards Board (IASB) and FASB formally announced their intention to pursue “convergence.” This will be covered in Chapter 10.

The Liability Crisis in Public Accounting

The liability crisis in public accounting has been an extremely important problem facing the entire profession. There has been tremendous pressure to turn the audit into a fraud-detection mechanism with the situation mentioned earlier of requiring the auditor to report to the SEC, in the case of publicly traded companies, if management and the board of directors do not act appropriately. Certainly, auditors are entitled to some share of the blame for cutting corners on audits in attempts to reduce costs as a result of “lowball” bidding on audits as well as supervisory inefficiencies and poor judgment. Schuetze has also leveled some charges against the standard-setting function in terms of ambiguity concerning revenue recognition rules and overly complex definitions of accounting elements.59

Doubtless, both auditors and standard setters share some part of the blame.60 Nevertheless, there have been some inherent problems in the legal system, combined with the fact that auditors are viewed as having very “deep pockets,” that have led to some reform in the most important part of the previously mentioned Private Securities Litigation Reform Act (PSLRA) of 1995.

Prior to PSLRA, auditors in both federal and state cases were subject to joint and several liability for damages suffered by third parties who relied on the financial statements of firms attested to by CPAs. Joint and several liability means that one party can be stuck with more than its proportionate share of the judgment caused by its actions. Narayanan gives the following graphic example of joint and several liability in which a girl was hurt in a bumper car accident at Walt Disney World.

<table>
<thead>
<tr>
<th>Responsibility</th>
<th>Damages Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plaintiff (girl)</td>
<td>14%</td>
</tr>
<tr>
<td>Boyfriend</td>
<td>85%</td>
</tr>
<tr>
<td>Walt Disney World</td>
<td>1% 86%</td>
</tr>
</tbody>
</table>

The boyfriend had no financial resources, so Walt Disney World was assigned 86% of the damages even though its responsibility was determined to be only 1% of the blame for the accident.61
This part of the PSLRA has put what appears to be a brake on federal court actions against auditors because of limitations set against the use of joint and several liability. Joint and several liability is not applicable unless the defendant “knowingly violates security laws.” In its place would be proportionate liability, which restricts liability to each defendant’s proportionate share of the damages based on the judge’s or jury’s assessment of the individual’s share of the damages.

One possible result of the PSLRA is that litigation against auditors may be shifted from federal courts to state courts. However, some states are putting their own limitations on joint and several liability and moving toward proportionate liability except where the defendants knowingly engaged in fraud.

Current Role of the AICPA

The AICPA no longer has exclusive authority in the private sector for promulgating auditing rules. SOX has relegated the Auditing Standards Board to a role of advising the PCAOB before it sets standards for auditing, attestation, and quality control. As audit firms became advocates for their clients rather than protecting public interests, and the AICPA campaigned for a broader certification that deemphasized a CPA’s auditing responsibilities, it relinquished its role as police officer for self-regulation. Post-SOX, the AICPA has been working to regain the public confidence lost during corporate debacles of the 2000s and attempting to find its niche within the new accounting standard-setting and reporting structure.

The AICPA has clearly lost power over the years with standard setting relegated to the FASB and PCAOB. One way to regain some power would be for the AICPA to become the standard-setting body for smaller firms (referred to as “baby GAAP” in private companies). There has been some question whether this differentiation should be small firms versus large firms or public versus privately owned firms. In either event, such a division would add complexity to the standard-setting process, especially if two standards-setting bodies were involved. Consequently, any distinction between small and large firms to avoid costs or complexity should be done exclusively by the FASB, the official standard-setting body. However, a recent collaboration between the AICPA and FASB proposes that the AICPA participate in a separate standard-setting process for private companies. It is puzzling as to why the FASB would want to give up this standard-setting authority. Even more troubling is the fact that the AICPA would be the representative of the privately owned firms. This proposal appears to be a very dangerous one. It is not a matter of different requirements for private versus public firms but rather the advocacy position that privately held firms would gain.

The AICPA still has an important role to curb what has been called “shopping for accounting principles,” which involves increasing competition among auditing firms to land clients. As the phrase implies, greater numbers of clients have tried to find an auditor who will either lowball its bid to secure a client or will go along with a questionable accounting method that the client desires to employ.

The opinion-shopping problem may have, in fact, led auditors to support totally outlandish positions, according to the former chief accountant of the SEC. Among other examples
mentioned, he discusses an airline that overhauled aircraft engines and mainframes. The costs were to be amortized over the future benefit period. However, the airline, aided and abetted by its auditor (two of them, in fact), attempted to classify the portion of the deferred charge that would be written off over the following year as a current asset. In light of these types of problems, the AICPA has been attempting to strengthen professional standards of conduct and rules of performance and behavior. Hence, the AICPA formed the AICPA Special Committee on Financial Reporting in 1991 with the charge of recommending what additional information management should provide for users and the extent to which auditors should report on this information.

### Current Role of the SEC

The SEC has statutory authority to set accounting standards for public companies. It has, as a matter of policy, been supportive of private-sector standard setting in general and the FASB in particular. In ASR 150, the SEC stated that financial statements based on accounting practices for which there is no substantial authoritative support will be presumed to be misleading. For the first time, accounting standards set in the private sector were formally recognized as having substantial authoritative support. Prior to ASR 150, this support was informal.

The SEC and FASB have had differences of opinion; generally, however, their relationship has been cordial and mutually beneficial. There have been instances in which the SEC pressed for greater attention to specific issues, but the FASB argued that resource constraints prevented it from addressing the SEC’s concerns. The new fees-imposed funding required by SOX may provide the necessary resources to adequately address “hot issues” and bring the two organizations closer together. Also, given the public’s growing distrust of financial statements, especially in light of the number of restatements, the FASB will likely become more conservative and more sensitive to the public’s interest. So, the likelihood of significant differences between the SEC and the FASB is relatively small. Given that the SEC now funds the FASB, the FASB has become more of a quasi-governmental body than a purely private sector one. Furthermore, the SEC is putting pressure on the FASB to exert more control over appointment of new members of the Board, including the opportunity to nominate new members. Whether this leads to increased politicization of the standard-setting process, only time will tell.

Another aspect of SEC operations involves electronic filing of financial data with the SEC via “EDGAR” (Electronic Data Gathering, Analysis, and Retrieval System). Most public domestic companies began filing electronically in 1996. While some problems have occurred, the program appears to be quite successful. A related development involves corporate reporting via the Internet. Research has found wide variation in timeliness of corporate information presented on the Internet. Some enterprises provide up-to-date information such as monthly sales, whereas others may present outdated information such as two-year-old financial statements. Financial reporting on the Internet will surely become much more important in coming years.
Other Groups

At least three professional associations other than the AICPA have an interest in the standard-setting process in the United States today: the AAA, the FEI, and the IMA.

The AAA has been concerned with accounting standards for many years. From 1936 to 1957, it sponsored several statements on accounting principles. In 1966, a committee appointed two years earlier to develop an integrated statement on basic accounting theory published *A Statement of Basic Accounting Theory*. Parts of this statement subsequently appeared in APB Statement 4, which has become significant in the development of the FASB’s conceptual framework project. An AAA committee issued a report calling for a special commission to study the organizational structure for establishing accounting standards at about the same time the Wheat Committee was being formed. Owing to the formation of the Wheat Committee, the AAA never formed its commission, but the initial committee report reflects the AAA’s obvious interest in the development of accounting standards. Zeff has observed that the AAA has played a more important role than is generally acknowledged at crucial turning points in the standard-setting process.71 Today, the AAA sponsors various research studies on accounting problems. These *Studies in Accounting Research*, of which there have been 33 to date, represent a significant contribution to the development of accounting theory. AAA subcommittees also respond to FASB exposure drafts.

The FEI’s technical committee on corporate reporting reviews all FASB discussion memorandums and exposure drafts and develops the official FEI position, which is communicated to the FASB. FEI also frequently participates in FASB public hearings. In addition, the FEI formed the Financial Executives Research Foundation specifically to fund various research projects in accounting and related areas. Numerous projects have been published to date.

Since its formation in 1919, the IMA has conducted research and published reports in the cost and managerial accounting areas. Recently, it has become more interested in external financial reporting and, as a consequence, formed its Committee on Accounting and Reporting Concepts. This committee responds to various FASB projects.

In addition to the three professional groups with an interest in accounting standards, an increasingly important organization is the International Accounting Standards Board, which will be examined in greater detail in Chapter 10. The Norwalk Agreement of 2002 formally established plans for the FASB and IASB to pursue convergence of international and U.S. accounting standards. Clearly, the IASB’s role in establishing standards is growing.

Summary

We have recounted a brief history of the three financial accounting policy-making bodies that have existed in the United States since 1930. Prior to that year, published accounting information was largely unregulated in this country.

As a result of cooperation between the AICPA and NYSE, work on drafting accounting principles was begun. A major impetus was, of course, the creation of the SEC, which was given the power by Congress to prescribe accounting principles. As a result, the CAP was formed, and
most of the responsibility for the policy-making function has remained in the private sector. In its existence, the CAP issued a total of 51 ARBs, the most famous being ARB 43. Toward the close of its existence, the CAP was increasingly criticized because it attempted to solve problems on a piecemeal basis without a coherent, underlying theory.

The APB was conceived with high optimism. Opinions were to be based on in-depth research studies, which, in turn, were to be grounded in a set of underlying postulates and principles: In other words, the deductive approach was to come into flower. Unfortunately, the rejection of ARS 3, the broad principles study, virtually put an end to the formalized deductive approach—despite the publication of the conservative ARS 7, which attempted to extract principles from existing rules. Despite considerable progress on many fronts, the very shaky start of the APB, combined with its own institutional weaknesses and its fumbling of the business combination issue led to the body’s demise.

The work of two important committees, one concerned with the organization of a new body and the other with the objectives of financial accounting, preceded the formation of the FASB. Board members were granted much greater independence, and the organization itself was separate from the AICPA. The FASB appears to have weathered a great deal of criticism leveled at it in its early years; however, the SOX Act of 2002 significantly changed how the FASB will operate in the future. Financially independent of accounting firms and corporations, but more closely aligned with the SEC, the FASB’s very existence is suspect unless it restores the public’s confidence in the accounting profession. Everyone appears to want the FASB to succeed, but the laws are in place to make movement to 100% government regulation relatively simple, if the FASB fails.

The liability crisis in public accounting, a huge problem for the entire profession, may be mitigated by moving from joint and several liability toward proportionate liability. This has largely occurred at the federal level through the Private Securities Litigation Reform Act of 1995, and it is just beginning to be felt in state securities law changes.

**QUESTIONS**

1. How did the APB pave the way for the FASB?

2. In what ways does the FASB differ most markedly from its two predecessors?

3. What is the weakness of Grady’s approach in arriving at principles in ARS 7?

4. Do you think that the nonbinding status of the FASB’s Statements of Financial Accounting Concepts (like that of APB Statement 4) is a good idea or not?

5. Discuss the significance of the SEC’s ASR 150.

6. What has been the SEC’s role in the evolution of the rule-making process? How has that role changed since the passage of SOX?

7. What were the politics that led to the demise of both the CAP and the APB?
8. The FASB's standard-setting procedure is a fairly narrow, cut-and-dried approach to developing accounting standards. Evaluate this statement.

9. Should constituents have input into the FASB decisions, or should the FASB neutrally and independently set standards?

10. Explain how the role and form of research used by the APB and FASB differ.

11. What is the importance of the FAF and FASAC to the success of the FASB?

12. The three attempts at standard setting in the private sector (CAP, APB, and FASB) have all dealt with the need for a theoretical foundation. Why were the CAP and the APB unsuccessful at this endeavor?

13. Can any overall trend be detected in FASB pronouncements? Explain and cite examples to substantiate your opinion.

14. In terms of financial reporting in the future, do you expect greater refinement of measurements appearing in the body of the financial statements or increasing disclosure with less effort directed toward refinement of measurements?

15. How has Sarbanes-Oxley of 2002 affected FASB’s jurisdiction and independence?

16. In late 1990s, the “Wyden Amendment” was stricken from the Crime Bill passed by Congress. The amendment would have required reporting by auditors on internal controls. Letters sent by FEI members opposing the amendment were instrumental in its defeat. The AICPA supported the amendment. From an agency theory perspective, why do you think the AICPA supported the amendment and the FEI was against it? Explain.

17. Since the FASB is independent from the AICPA, the latter is no longer concerned with standard setting and related issues. Evaluate this statement.

18. What is the relationship between the National Commission on Fraudulent Financial Reporting and the Private Securities Litigation Reform Act of 1995?

19. What is the difference between joint and several liability and proportionate liability?

CASES, PROBLEMS, AND WRITING ASSIGNMENTS

1. During its long tenure, the CAP produced a total of 51 ARBs. While the CAP was in existence, another committee, the Committee on Terminology of the American Institute of Accountants (the previous name of the AICPA), prepared certain definitions. Assess their definitions of assets and liabilities (see Chapter 11 for the definitions). Do you see any problems with one committee preparing rules and another making definitions?

2. Read Chapter 15 of ARB 43 on unamortized discount, issue cost, and redemption premium on bonds refunded. Why do you think these issues concerned the committee? What were the two
acceptable alternatives for dealing with the costs of any issue? Why would the definition of assets be helpful in analyzing a situation of this type? Are there any other situations that might be somewhat analogous to the bond redemption situation? (ARB 43 should be available in your university’s library.)

3. Read “FASB Response to SEC Study on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers” (Feb. 2006). How would you frame the tenor of the FASB’s response. To what extent does it agree with the SEC’s study?

4. Five so-called broad principles of accounting were prepared by the AICPA’s Special Committee on Cooperation with the Stock Exchange and approved by the NYSE’s Committee on Stock List in 1932. They were to be followed by all firms listed on the exchange. Subsequently, these principles (along with a sixth item) were codified as Chapter 1 of ARB 43 and are printed here.

a. Unrealized profit should not be credited to income account of the corporation, either directly or indirectly, through the medium of charging against such unrealized profits amounts that would ordinarily fail to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as the packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

b. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges that would otherwise fail to be made there against. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges that would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

c. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

d. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

e. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

f. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

Now listed here are two principles from ARS 7 as well as some additional comments. This study was done under the auspices of the APB and was published in 1965.
Principle B-1. In case there are two or more classes of stock, account for the equity capital invested for each and disclose the rights and preferences to dividends and to principal in liquidation.

Principle B-4. Retained earnings should represent the cumulative balance of periodic earnings less dividend distributions in cash, property, or stock, plus or minus gains and losses of such magnitude as not to be properly included in periodic earnings. The entire amount may be presumed to be unrestricted as to dividend distributions unless restrictions are indicated in the financial statements.

This principle is closely parallel to the definition of earned surplus in Accounting Terminology Bulletin No. 1, paragraph 34, which follows:

The balance of net profits, income, gains, and losses of a corporation from the date of incorporation (or from the latest date when a deficit was eliminated in a quasi-reorganization) after deducting distributions therefrom to shareholders and transfers therefrom to capital stock or capital surplus accounts.

Terms such as “principles of accounting” have been used frequently since 1932. Describe what you think the principles might be. Do any of the principles coming from ARB 43, Chapter 1, or ARS 7 qualify as principles as you have construed them? How similar are these two partial groups of principles?

CRITICAL THINKING AND ANALYSIS

1. Why have management consulting operations created problems for the public accounting industry? How has SOX affected these problems?
2. The FASB and AICPA are considering the addition of “baby GAAP” for private companies. Take a position and argue why two GAAPs should or should not exist.
3. What role should the AICPA assume in the possible development of “baby GAAP” standards?

Notes

2. Storey (1964, pp. 3–8).
4. See Ray (1960). The questions have arisen again in relation to cost accounting practices by American industry. For an interesting discussion, see Boer (1994).
7. Storey (1964, p. 12).
8. Healy (1938, p. 5).
9. SEC (1938, p. 5).
11. Ibid. (p. 139).
12. SEC (1939, p. 121).
16. This conflicted with ARB 35, which called for extraordinary items to be in the surplus statement (Statement of Retained Earnings). See Zeff (1972, pp. 157–158).
17. Spacek (1957, p. 21).
18. AAA (1957, pp. 1–12).
21. Although the term substantial authoritative support is not defined in APB Opinion No. 6, it has developed a meaning over the years that encompasses—in addition to pronouncements of rule-making bodies and the SEC—opinions of regulatory commissions, provided they do not conflict with statements from other sources, recognized textbooks, leading CPAs, and practices that are commonly followed by business. See Grady (1965, p. 16).
22. The CPA Letter (1965, p. 3).
27. Ibid. (p. 66).
28. AICPA (1972, p. 72).
30. Ibid. (pp. 172–177).
32. Ibid. (pp. 181–182).
33. Ibid. (p. 183).
34. Ibid. (p. 184).
35. FAF (1977, p. 55).
36. Ibid. (p. 18).
37. Action Alert is available as an electronic notification service from FASB. Free subscription to the service is available on FASB’s Web site: www.fasb.org.
42. Ibid.
43. Dopuch and Sunder (1980, p. 19) were unhappy with the change to the 4-to-3 vote. Sunder (1988) saw the problem as bureaucratic pressure on the FASB to produce standards because of the relatively large size of its staff and the scope of its operations, as well as the fact that a sizable portion of its revenues stemmed from the sale of standards, interpretations, and other official documents.
44. Pasewark (2002) shows that the 4-to-3 vote, not surprisingly, leads to a passage of more standards in a shorter period of time than the 5-to-2 supermajority.
46. AICPA (1978, p. 15).
47. See Meyer (1974), Rockness and Nikolai (1977), McEnroe and Nikolai (1983), and Moody and Flesher (1986).
49. Ibid. (p. 243). Brown noted (p. 241) that the FASB’s position appeared to be closest to the Financial Analysts’ Federation, a group representing user interests.
51. Ibid. (p. 103).
52. Schroeder (2000).
54. Ibid. (p. 36).
60. It should be borne in mind that major public accounting firms act as consultants to law firms engaged in litigation against other major public accounting firms. To some extent, public accounting firms are on both sides of the liability issue, although consultant’s fees are far below judgment claims.
62. King and Schwartz (1997, p. 94). There is also a minimum wealth and loss condition in which the defendant would still be joint and severally liable even in the absence of knowingly violating security laws. This occurs if the plaintiff’s net worth is less than $200,000 and losses suffered exceed 10% of his or her net worth.
64. Palmrose (1997). Illinois enacted legislation against joint and several liability in negligence cases in which the auditor is responsible for less than 25% of the total damages. In Texas, joint and several liability applies only when the defendant is responsible for more than 50% of the damages.
68. See Anderson and Ellyson (1986) and Connor (1986).
69. For more on the relationship between the SEC and the FASB, see Sprouse (1987).

References


