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The Formulation of Accounting Policy

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THE FORMULATION OF ACCOUNTING POLICY

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LIST OF ABBREVIATIONS

AIA	American Institute of Accountants
AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board
ARB	Accounting Research Bulletin
ARS	Accounting Research Study
ASR	Accounting Series Release
CAP	Committee on Accounting Procedure
CPA	Certified Public Accountant
FAF	Financial Accounting Foundation
FASAC	Financial Accounting Standards Advisory Council
FASB	Financial Accounting Standards Board
FEI	Financial Executives Institute
FTC	Federal Trade Commission
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SFAC	Statement of Financial Accounting Concepts

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CHAPTER I

INTRODUCTION

Years ago, when businesses were small and owners were directly involved in the functioning of their businesses, there was little need for external financial reporting and therefore, little demand for standards governing the valuation and disclosure of accounts and results of operations. Then, as larger businesses evolved and ownership and management functions separated, the need was recognized for a set of policies to ensure full and fair disclosure of management's activities. This brought with it the need to establish a policy making body to promulgate accounting and reporting standards.

In general, policy making has been defined as "the process by which individuals or groups in power choose general rules for action that may affect others within an organization or perhaps within an entire society."[1] Within the accounting profession, that process has evolved through time to its present complex state. Myriad related factors must be considered in the formulation of accounting policy.

What events caused the evolution of accounting policy formulation once its need was recognized, and how has it evolved to its present

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[1]Charles T. Horngren, "Will the FASB be Here in the 1980s?" Statement in Quotes, The Journal of Accountancy 142 (November 1976):90.

state? What factors are considered by policy makers in establishing these standards? What are the reactions of those governed by them and how does this affect policy maker's decisions?

This study begins by tracing the formulation of accounting policy from the recognition of its need in the 1920s to the two present policy making bodies, the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB). It then goes on to describe the procedures followed by both the FASB and the SEC in promulgating accounting standards. The next section explores the relative power held by each of the two policy making groups and the relationship that exists between them, including several recent conflicts. This is followed by a discussion of the political, social, and economic factors considered by policy makers in establishing standards and gaining acceptance of their promulgations. Finally, a description of two proposed models of the standard setting process will be presented.

CHAPTER II

A HISTORY OF ACCOUNTING POLICY FORMULATION

Prior to the 1930s there seems to have been very little in the line of accounting policies. The general consensus at that time was to let the corporations govern themselves. Self-regulation was the accepted way to control financial reporting and the securities markets in the 1920s. What little regulation there was during that time was governed mainly by the Federal Reserve System, the only regulatory agency that was directly involved in the private financial system. Other government agencies that played a part in the regulatory process included the Treasury Department, the Internal Revenue Service, the Department of Commerce, the Federal Trade Commission (FTC), and the Justice Department. In spite of suggestions that there should be more regulation of the securities markets, no effective attempts were made to regulate securities. The stock market was booming and things appeared to be going well. That is, until the bottom dropped out and the stock market crashed in 1929.

Enter the SEC

As a result of the crash in 1929 and the market failures of the early 1930s, the Securities Act of 1933 was passed by Congress to provide for fuller disclosure by companies offering securities for the first time in the public markets. Originally, the authority to enforce the 1933 Act was given to the Federal Trade Commission, the agency with which corporate filings were to be made. The FTC then had the power to require modifications of a registration statement filed with it or issue a stop order suspending the registration if it had reason to believe that the registration statement contained untrue information or that material facts had been omitted.

The 1933 Act was closely followed by the Securities Exchange Act of 1934, which provided for continuing disclosures by corporations whose securities were publicly traded. The 1934 Act also provided for the formation of the Securities and Exchange Commission (SEC), an independent agency created to administer the 1933 and 1934 Acts as well as several other regulatory laws.

In form, the SEC consists of five members appointed by the President with one member designated as chairman. The Commission is assisted in the performance of its duties by a professional staff organized into divisions and offices, including the Division of Corporate Finance and the Office of the Chief Accountant, which are most closely involved in accounting issues.

The powers originally vested in the FTC were transferred to the Securities and Exchange Commission. The SEC was also authorized by Section 19 of the 1933 Act[2] to define accounting terms, prescribe forms for presenting financial information, including the details to be shown in income statements and balance sheets, and designate methods to be followed in the preparation and valuation of accounts. In

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[2] Robert Chatov, Corporate Financial Reporting: Public or Private Control? (New York: The Free Press, 1975): 311.

addition, the SEC could require that accepted accounting principles, newly formulated principles, or both be followed by the accounting profession in filing registration statements.

In spite of its authority, the SEC increasingly looked to the accounting profession for advice and opinions regarding accounting issues until in 1937, the decision was made to turn the responsibility for making accounting rules over to the profession. The decision carried with it, however, the stipulation that if the accountants did not do it, the SEC would.[3]

The CAP: 1938-1959

The profession's new responsibility landed squarely in the lap of the American Institute of Accountants (AIA), the organized body of accounting practitioners whose name was later changed to the American Institute of Certified Public Accountants (AICPA). In response, the AIA created the Committee on Accounting Procedure (CAP) in 1938 to conduct research that would lead to a body of generally accepted accounting principles. The new committee was composed of twenty-two members with the president of the AIA designated as chairman. The members could come from different geographical areas, different size firms, and the teaching profession; however, all were to be members of the AIA. The CAP was supported by a research staff consisting of two members; a director and one full-time assistant.

To begin with, the focus of the committee was on providing guidelines to the profession and recommending preferred alternative practices, as can be seen in its report to the AIA in 1939:

[3] Ibid., p. 130.

> The present plan of the committee is to consider specific topics, first of all in relation to the existing state of practice, and to recommend, whenever possible, one or more alternatives as being definitely superior in its opinion to other procedures which have received a certain measure of recognition and, at the same time, to express itself adversely in regard to procedures which should in its opinion be regarded as unacceptable. In considering each case, particularly where alternative methods seem to have substantial merit, it will aim to consider the conflict of considerations which make such a situation possible and thus gradually to prepare the way for further narrowing of choices.[4]

The CAP then began issuing Accounting Research Bulletin (ARBs), expressing its opinions on various accounting issues. In spite of the committee's stated goals, the ARBs were largely definitional in nature, dealing mostly with reporting and disclosure requirements and not so much with setting accounting principles.

Then, in response to a growing demand for a codified set of "generally accepted accounting principles," the CAP annouced in its 1949 report to the AIA that of the proposals being considered, "first and perhaps foremost is a proposal for an overall statement of accounting principles."[5] The committee's efforts resulted in ARB No. 43, "Restatement and Revision of Accounting Research Bulletins" (1953), a disappointment to many in that it was not the codification desired.

One of the difficulties faced by the CAP was the implementation of its research bulletins. The committee had no direct power to place

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[4] Maurice Moonitz, Obtaining Agreement on Standards, Studies in Accounting Research No. 8, (Sarasota, FL: America Accounting Association, 1974), p. 13.

[5] Ibid.

its findings into operation by requiring their use in practice, even by members of the AIA itself; as expressed in Paragraph 8 of the introduction to ARB No. 43:

> Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of opinions reached by the committee rests upon their general acceptability.[6]

Therefore, the committee had to rely explicitly on persuasion rather than compulsion to gain acceptance of its opinions, although the SEC did support the CAP's efforts by announcing that it would not accept financial statements filed with it that did not follow ARB recommendations.

It soon became clear that the accounting and business communities were not satisfied with the committee's efforts, as evidenced by the mounting criticism against the CAP. The brunt of the criticism against the committee was for not establishing a foundation for accounting principles, not establishing the principles themselves, and not using a public forum for their determination. In short, the committee was, as Charles T. Horngren put it, "too concerned with putting out brush fires and too wedded to an ad hoc approach that lacked an overall conceptual framework."[7]

The severe criticism brought about action by the AICPA, whose name had recently been changed from the former AIA. In 1957, the ten-member Special Committee on Research Programs was appointed to investigate the criticisms against the CAP and to make recommendations.

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[6] Ibid., p. 16.

[7] Horngren, "Will the FASB be Here in the 1980s?" p. 90.

The APB Era

The special committee submitted its recommendations in September of 1958. Included therein was a recommendation for the creation of a new policy making body, and thus the Accounting Principles Board (APB) was born. The new Board was to be more streamlined than its predecessor, consisting of eighteen members rather than twenty-two. Again the membership was to be made up of AICPA members, but now different areas of interest would also be represented. Twelve of the members were to be public accountants, three university accounting professors, two financial executives, and one director of research. The special committee also recommended an increase in the size of the research staff to include eight analysts in addition to the director.

The special committee's report also carried with it a recommendation as to the purpose of the APB and the AICPA in general:

> The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles, for the guidance of its members and of others. This means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can and it should take definite steps to lead in the thinking on unsettled and controversial issues.[8]

In addition, the report called for two research projects: the "basic postulates of accounting" and a "fairly broad set of

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[8]Special Committee on Research Programs, "Report to Council," The Journal of Accountancy 106 (December 1958): 62-63.

coordinated accounting principles" formulated on the basis of the "postulates."[9]

Several attempts were made by the APB to meet these recommendations. The first attempts were two studies on accounting postulates and principles. Accounting Research Studies (ARS) Nos. 1 and 3, submitted to the Board by its Accounting Research Division. Although the Board allowed the studies to be published, they were rejected by the APB as too radically different from generally accepted accounting principles for acceptance at that time and included a statement to that effect.[10] They were followed by ARS No. 7, an inventory of generally accepted accounting principles as they exist in practice, which was largely ignored by the APB. Finally, in 1970, the Board issued APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," which covered much the same ground as ARS No. 7. Note, however, that it was issued as a statement, not an opinion, and was therefore, as Maurice Moonitz put it, "binding on no one for any purpose whatsoever,"[11] as opposed to an opinion which carried more weight. Thus the APB fell short in its attempt to reach the goals set for it by the special committee.

A further look at the APB's track record reveals that the Board issued 31 opinions and 4 statements between 1959 and 1973, most of which dealt with the form of financial statements, including disclosure in general, but not affecting the net income of the reporting company.

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[9] Ibid.

[10] Moonitz, p. 18.

[11] Ibid.

The APB had the most success with its recommendations affecting the form of presentation, the amount of detail, and the extent of disclosure, but not the results of operations. Those opinions expressing principles affecting the amount of periodic net income that received acceptance in practice were usually preceded by research studies published and widely distributed for an extended period before the APB acted.[12]

The APB was following in the footsteps of its predecessor, the CAP, in that it relied on persuasion rather than compulsion for implementation of its opinions. As a result, the Board was ineffective in promulgating principles in controversial areas. Attempts were made by the Board to formulate principles on such topics as the investment tax credit, purchase vs. pooling methods for business combinations, and income tax allocation. Although some were successful, most either required modifications of the original proposal to gain acceptance or ended in a standstill. For example, in formulating a principle dealing with the reporting of marketable securities, the APB mini-exposed its preferred solution to the SEC, the insurance industry, and other actively involved groups before issuing an exposure draft. The insurance industry's reaction was a blitzkrieg of Washington, D.C., to prevent issuance of the opinion, and the SEC refused to support the method preferred by the APB. The Board reconsidered and introduced a second acceptable alternative, which was again strongly opposed by the insurance industry. The SEC informed the Board that it would

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[12] Ibid., p. 28.

not impose a solution on an industry that was adamantly opposed to it. The APB's third attempt was again met by strong opposition from industry and no support by the SEC. The scenario ended with a report by the APB to the SEC summarizing the Board's actions and describing the alternatives but offering no preferred solution.

The buffeting taken by the Board in attempting to resolve difficult issues led it, in its later years, to avoid them and concentrate on less controversial topics.[13] The APB's ineffectiveness was attributed to its inability to resolve major reporting issues, slow response to urgent problems, and neglect of viewpoints from all parties affected by accounting policy.[14] Like the CAP before it, the Accounting Principles Board had failed in issuing a binding statement on accounting principles. And again, the policy making body was subjected to severe criticism. Representative of the criticism received by the APB was this comment in 1972 by John C. Burton, then Chief Accountant for the SEC:

> In abdicating its professional responsibility, the accounting profession has pointed the finger at generally accepted accounting principles and thereby the Accounting Principles Board. In so doing, it has urged the Board to define accounting principles more precisely, so that the number of loopholes which exist for misleading reporting may be reduced.
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> The Board has responded with increasingly long, complex and legalistic Opinions which have closed a number of loopholes after they have been exploited.[15]

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[13]Ibid.

[14]Lauren Kelly-Newton, Accounting Policy Formulation: The Role of Corporate Management (Reading, MA: Addison-Wesley Publishing Company, 1980), p. 8.

[15]John C. Burton, "An Educator Views the Public Accounting Professions," The Journal of Accountancy 132 (September 1971): 50.

The AICPA responded to the criticism by appointing a study group, the Study on Establishment of Accounting Principles, Francis M. Wheat, Chairman (the Wheat Committee), to examine the operations of the APB and its objectives.

The Creation of the FASB

The recommendations of the Wheat Committee, whose report was submitted to the AICPA in March of 1972, included the creation of a three-part independent organization to replace the Accounting Principles Board. The Wheat Committee's recommendations were adopted, and the present policy-making organization was formed. The three-part organization consists of the Financial Accounting Foundation (FAF), the Financial Accounting Standards Board (FASB), and the Financial Accounting Standards Advisory Committee (FASAC).

The Financial Accounting Foundation was originally composed of nine trustees; the president of the AICPA as an ex-officio member and eight members selected by the AICPA board of directors. This was amended in 1977 to eleven members representing the six organizations sponsoring the operation of the FAF: American Accounting Association, AICPA, Financial Analysis Federation, Financial Executives Institute (FEI), National Association of Accountants, and Securities Industry Association. The FAF trustees all serve on a voluntary, unpaid basis.

The duties and responsibilities of the FAF are four-fold:

(1) appointing members to the FASB and the FASAC,

(2) obtaining funds and approving budgets for the three groups.

(3) overseeing the plans and operations of the FASB and the FASAC, and

(4) periodically reviewing the mechanism for setting financial accounting standards in the private sector.[16]

The actual policy-making body of the three-part organization is the Financial Accounting Standards Board, made up of seven members. Originally, the seven member board was to consist of four accounting practitioners and three others who were well versed in the problems of financial reporting, including corporate financial executives, accounting educators, and the Federal Government Accountants Association. Due to the 1977 revision, the only requirements for becoming a member now are knowledge of accounting, finance, and business, and a concern for the public interest. Once appointed to the FASB, members are required to relinquish all affiliations held prior to appointment. Members are full-time, salaried, and may serve for up to two terms of five years each. During that time they are to maintain independence from outside pressures and interest groups.

The FASB is responsible for the establishment of financial accounting and reporting standards and is authorized to conduct all activities necessary to fulfill that purpose, including the appointment of task forces to study specific problems. Note the change in emphasis from the conceptual framework requested of the CAP and the APB to a more pragmatic approach. As expressed by Charles

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[16] Kelly-Newton, p. 8.

T. Horngren, "There are no grandiose schemes for erecting an elegant conceptual framework and then issuing pronouncements. Instead, such work is only one of a growing multitude of projects."[17]

The third leg of the triangular organization is the Financial Accounting Standards Advisory Council (FASAC). The FASAC is composed of a minimum of twenty members chosen to provide a broad representation of the FASB's constituencies. The purpose of the FASAC is to serve in an advisory capacity to the FASB by consulting with it regarding major technical issues, its agenda of projects and priorities, the appointment of task forces, and comments concerning proposed and effective pronouncements.

These three bodies, the FAF, the FASB, and the FASAC, constitute the standard setting organization in the private sector today.

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[17] Horngren, "Will the FASB be Here in the 1980s?" p. 90.

CHAPTER III

PRESENT STANDARD SETTING PROCEDURES

Little has been said to this point about the actual mechanical process of setting standards. This chapter describes the standard setting procedures followed in both the private sector, by the FASB, and the public sector, by the SEC.

Procedures Followed by the FASB

In the private sector, the Financial Accounting Standards Board issues several different types of pronoucements in establishing financial accounting and reporting standards. The Statement of Financial Accounting Standards (SFAS) is the main type of pronouncement, used by the FASB to formulate policies regarding the accounting for and the presentation of financial information. The FASB may also issue Statements of Financial Accounting Concepts (SFACs), which are used to establish the theoretical foundations underlying the financial accounting and reporting standards. In addition, Interpretations may be issued to further clarify or exemplify the information contained in the SFASs, SFACs, or previously issued APB Opinions or Accounting Research Bulletins, which remain in effect until superceded by FASB action.[18]

Certain rules of procedure are followed by the FASB prior to the issuance of a statement to ensure a thorough study of the

[18] Kelly-Newton, p. 9.

relevant issues and allow for public participation in the standard-setting process.[19] The first step in the process involves the work of the Screening Committee on Emerging Problems, which is made up of representatives from the FASB, the FASAC, and other interested parties. The Screening Committee identifies emerging problems, evaluates them to determine whether they are new problems or if they are currently on the Board's agenda or delayed to a later date, and advises the FASB on which problems should be considered and what their priority should be. Once a problem has been identified, approved, and given priority, the Director of Research and Technical Activities assign one or more persons from the FASB technical staff to work on the project. A task force is then appointed by the Chairman of the FASB with the advice of the FASB, the FASAC, and the Director of Research and Technical Activities. The task force consists of people with expertise in or a viewpoint relevant to the issue under consideration and has the responsibility for giving advice in defining the problem and the scope of the project to be undertaken, identifying the need for additional research, and assisting in the preparation of the discussion memorandum.

The discussion memorandum is a neutral document which sets forth a definition of the problem being considered, the scope of the project, the financial accounting and reporting issues involved, the relevant literature and research findings pertaining to the issue, and the alternate solutions under consideration as well as the

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[19] Financial Accounting Standards Board, "Rules of Procedure Amended and Restated," (Stamford, CT: FASB, 1978), cited by Kelly-Newton, pp. 9-10.

arguments and implications of each alternative. The discussion memorandum is widely distributed to the public and written comments are invited. Together, the discussion memorandum and comments received become the basis for a public hearing at which time all interested parties may make oral presentations or submit written position papers regarding their views. After consideration has been given to the written and oral comments as well as the research performed by the task force, the FASB prepares an exposure draft, which is no longer a neutral document but rather a draft of the proposed SFAS or SFAC being considered by the Board. The exposure draft is then released for public review and further written comments from interested parties. If necessary, a second hearing may be held and modifications made to the exposure draft. The process may be repeated until a majority of the FASB approves the final document at which time a statement is issued and the process is completed.

The SEC's Procedures

Unlike the FASB, the procedures followed by the SEC in its rule making process are flexible and informal. Section 553 of the Administrative Procedures Act[20] sets forth the general process to be followed in agency rule making in general and therefore by the SEC. Its requirements include a general notice of the proposed rule, the solicitation of views from interested parties, a statement of the basis and purpose of the adopted rule, and the receipt of petitions by outside parties desiring repeal of the rule. However, no formalized procedures are practiced by the SEC for considering the views of

[20] Kelly-Newton, p. 12.

outside parties prior to the issuance of the proposed rule. Public hearings are held in some cases but not all.

The SEC's rule making process is often set into motion by indirect means, such as by comments on SEC filings or discussion of a controversial topic by Commissioners. The process begins with the appointment of a group of SEC staff members who are given responsibility for the project. The SEC then drafts a proposed rule on the issue, based on its experience and opinion, which is then published and distributed. The staff appointed to the project receives comments on the proposed rule which are considered along with other factors, such as the perceived need for the rule and public interest in it, in formulating a recommendation for final action by the SEC. The recommendation by the staff includes a statement of the issues, reasons for the suggested solution, potential consequences from its adoption, comment letters received, and a draft of the proposed Accounting Series Release (ASR). The SEC considers the recommendations of the staff in an open meeting and makes any modifications necessary, then releases the ASR.

The SEC's rule making process has been modified slightly as a result of recommendations made by the Advisory Committee on Corporate Disclosures, created by the SEC in 1975 to re-examine the present system of corporate disclosures in light of the 1933 and 1934 Securities Acts and the SEC's role in that system. The committee found the disclosure system to be sound, but it did, however, recommend that; (1) the rule making process be initiated by the SEC when a reporting issue was identified rather than by the indirect means currently practiced, (2) a concept release be issued prior to the proposed rule to alert the public, expose the SEC's views, and invite comments, and (3) the SEC promptly withdraw proposals that had not been acted on within a specified period of time.

The SEC's response to the committee's recommendations were noncommital with respect to the first two suggestions. The third suggestion was rejected as undesireable in that the difficult nature of many issues made adherence to a timetable impractical.[21]

However, the SEC has now begun to issue concept releases in some instances prior to the proposed rule to alert the public that the SEC is considering an issue, give the SEC's tentative views with respect to the issue, and invite public comment. Unlike the FASB's discussion memorandum, the concept release is not a neutral document, rather it provides the SEC's preliminary response to an issue and its intended course of action.

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[21]Securities and Exchange Commission, "Preliminary Response of the Commission to the Recommendations of the Advisory Committee on Corporate Disclosure," Release Nos. 33-5906 and 34-14471, (Washington, D.C.: The U.S. Government Printing Office, July 1978), cited by Kelly-Newton, p. 15.

CHAPTER IV

THE RELATIONSHIP BETWEEN THE FASB AND SEC

With the presence of two accounting policy making bodies, the FASB and the SEC, it is easy to see the potential for conflicts between them and wonder how they can exist side by side. Or are they "side by side?"

This chapter discusses the relative power and authority held by each group, their relationship to each other, and some examples of conflicts between them.

Power Relationships

For any rule-making body to be effective, it must have the authority to make the rules and the power to enforce them. This power may come in different forms; from coercive power, which includes the ability to punish for noncompliance, to legimate power in which the rule maker holds delegated authority, to expert power in which the rule maker is perceived as being an expert in that particular area.

When it was created, the Securities and Exchange Commission was given coercive power over corporations governed by its filing requirements under the 1933 and 1934 Securities Acts. The Securities Acts gave the SEC the authority to set forth the forms, procedures, regulations, and requirements deemed necessary to ensure full and fair disclosure. To enforce these requirements, the SEC has procedures for monitoring compliance. Filings are reviewed by the Division of Corporate Finance, and any revisions necessary in the registration statement are described in a letter of comments sent to the corporation. The corporation may appeal if it so desires; however, failure to comply with the SEC's final decision may result in a number of possible adverse consequences. Should the corporation allow the registration to become effective even though it did not meet SEC requirements, it could be exposed to legal liability for the disclosure of false or misleading information. The SEC also has the power to issue a refusal order, which would block the registration statement from becoming effective, or even a stop order, which would discontinue trading of the corporation's securities on the markets. Because of the SEC's power there is little that management can do but comply if the corporation's securities are to be publicly traded.[22]

The Financial Accounting Standards Board's power is not nearly as well-defined as the SEC's, having evolved over the history of policy making in the private sector. As previously discussed, the authority for setting standards was delegated to the private sector by the SEC in 1937, resulting in the creation of the CAP, later the APB, and finally the FASB. As history indicates, reliance was placed almost entirely on the persuasion of affected parties, the underlying logic of pronouncements, and the support of the SEC and the New York Stock Exchange to effect implementation of newly formed standards.[23]

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[22]Kelly-Newton, p. 55.

[23]Ibid., pp. 56-61.

The first authoritative pronouncement came in 1964 when the APB issued Opinion No. 6, which required the disclosure of departures from APB Opinions, thereby adding weight to the opinions. This was followed by support from the AICPA in 1972 when Rule 203 of its Code of Professional Ethics was adopted requiring CPAs to disclose all deviations from generally accepted accounting principles. The AICPA later stated that generally accepted accounting principles were determined by the FASB, thus making noncompliance with FASB pronouncements a breach of ethics.

The SEC also offered support to the FASB by releasing ASR No. 150 in 1973, which states in part:

> Principles, standards, and policies promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support.[24]

That statement, in combination with the statement in ASR No. 4 that disclosures would be considered misleading by the SEC if they deviated from accounting principles with authoritative support, gave the FASB an additional source of authority.

Still, the FASB has no legislative authority to enforce its statements and must rely to a great extent on voluntary acceptance. Without the ability to punish management for noncompliance, the FASB's power is limited to legitimate power; that is, acceptance of the FASB

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[24] Securities and Exchange Commission, "Statement of Policy on the Establishments and Improvement of Accounting Principles and Standards," Accounting Series Release No. 150, (Washington, D.C.: U.S. Government Printing Office, December 20, 1973), cited by Kelly-Newton, p. 58.

by the business community as having the authority to set standards. This legitimate power is largely due to the support given the FASB by the SEC.

The only enforcement procedure available to the FASB for noncompliance by management is to require that a qualified opinion be given on the financial statements. Disagreements such as this have in the past led management to "shop around" for an accountant more likely to concur with its practices, thereby circumventing those standards it did not wish to comply with. This practice has now largely been discouraged by two SEC requirements; first, that only unqualified audit reports are accepted in filings with the SEC and, second, that if a corporation changes CPA firms it must file a Form 8-K disclosing the reasons for the switch and all accounting and auditing disagreements in the last two years, as well as requiring a separate statement from the CPA giving his/her view of the disagreements if different from that of management.

The FASB's lack of coercive power has been identified by Maurice Moonitz in Studies in Accounting Research No. 8 as being its major weakness:

> The history of the numerous attempts to set standards... tells us that the Achilles' heel of the FASB is its reliance on voluntary cooperation. It tells us that reliance on voluntary, willing "adherence" to the standards of an agency without explicit powers of enforcement is illusory. Management will cooperate when it has no other choice, or when it suits its own goals and objectives, but not otherwise.[25]

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[25] Moonitz, p. 87.

Although the SEC does have the coercive power to enforce reporting standards, it has preferred to leave their promulgation up to the FASB for the most part. The reasoning behind this preference is that the FASB has greater resources for developing standards as well as more technical expertise and awareness of emerging problems.[26] Another reason is the desire to avoid two sets of accounting principles, one applicable to publicly-held and the other to privately-held companies.[27] However, the SEC may issue an Accounting Series Release if it believes that the FASB is not responding to a problem.

Decentralized Management

It appears, then, that the SEC has the coercive power, received from Congress, to set standards and enforce them but does not wish to do so. Rather, it has passed the responsibility to the FASB, which has accepted that responsibility but lacks the power needed to enforce it. The FASB must therefore depend on voluntary acceptance and "allies" such as the SEC for support to implement its standards. According to Charles T. Horngren, Professor of Accounting at Stanford University's Graduate School of Business, this relationship among Congress, the SEC, and the FASB is analogous to decentralized

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[26] Chatov, pp. 176, 178.

[27] Securities and Exchange Commission, "The Role of the Commission," Excerpt from The Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role, (Washington, D.C.: U.S. Government Printing Office, July 1978), cited by Kelly-Newton, p. 58.

management in industry.[28]

Decentralization is defined by Horngren as "the relative freedom to make decisions" and is adopted by top management "when it believes that lower management has more information and ability to make decisions that obtain the overall goals of the organization."[29] Decentralized management may be subject to recentralization, either partially or totally, if top management should decide to do so.[30]

There is much similarity, he says, between the organizational structure described above and that of the Congress, SEC and FASB. He describes Congress as top management with ultimate power to set accounting standards, which has largely been delegated to the SEC. The SEC in turn has delegated much of its power to lower management, the FASB. Constraints are set by upper levels of management, Congress and to some extent the SEC, and the whole organization is influenced by customers, those parties affected by the product, accounting standards.[31]

The product, accounting standards, must of course be acceptable to customers. If not, the customers must be persuaded otherwise or they will complain to upper levels of management, the SEC and Congress. Customers affected by standards may in the short run

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[28] Charles T. Horngren, "Accounting Principles: Private or Public Sector?" The Journal of Accountancy 133 (May 1972): 38-39.

[29] Charles T. Horngren, "The Marketing of Accounting Standards," Statement in Quotes, The Journal of Accountancy 136 (October 1973): 62.

[30] Ibid.

[31] Ibid.

have no alternative but to comply if Congress perceives the standards produced by lower management to be desirable for the public good. However, in the long run, Congress may be influenced by the fact that customers may ultimately, in an indirect way via votes, replace top management.[32]

Naturally, there are many who disagree with Horngren's analogy of decentralized management in industry. The relationship was described by SEC Chairman William J. Casey in an address to the annual meeting of the AICPA in 1972 as a partnership. This view was reiterated by John C. Burton, then Chief Accountant of the SEC, in response to Professor Horngren's analogy:

> ...as Chairman Casey said, we are in partnership... I do not believe that we are top management with veto power, although such power does legally exist. As a practical matter the strength of the private sector would dry up if Professor Horngren's article were a reflection of realty. No person of quality would want to serve on a principles board.[33]

Recent Conflicts

Regardless of the theoretical views held as to the Congress-SEC-FASB relationship, in actuality the private sector has experienced pressure from both the SEC and Congress in its promulgation of accounting and reporting standards. As an example, witness again the scenario involving the Accounting Principles Board, the SEC,

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[32] Ibid.

[33] "Paper Shuffling and Economic Reality," an interview with John C. Burton, News Feature, The Journal of Accountancy 135 (January 1973): 26.

and accounting for marketable securities described in a previous chapter. After three attempts to issue a preferred solution, each of which was strongly opposed by the insurance industry and unsupported by the SEC, the APB was finally forced to give up. In a letter received by Horngren, an observer of a visit by representatives of the APB to the SEC wrote that an SEC commissioner had

> ...asked the APB for a summary of the alternative methods together with the pros and cons of each. He also said that, once the SEC received this report, the SEC would tell the APB the parameters in which the APB could consider the subject. Presumably any method selected by the APB within the parameters would be acceptable to the SEC... This event is perhaps the clearest demonstration of an SEC order to the APB that I can recall.[34]

A more recent example involves accounting in the oil and gas industries. When the Energy Policy and Conservation Act of 1975 was passed, the SEC was charged with the responsibility for developing uniform accounting procedures to be used by oil and gas producers in reporting to the Department of Energy. True to form, the SEC passed this responsibility on to the FASB.[35] An exposure draft was issued by the FASB in 1977 calling for the mandatory use of the successful efforts method, which required that only the costs of successful exploration activities could be capitalized while the costs of dry holes would be treated as current period expenses. The full-cost method, which allowed the capitalization and subsequent amortization of all exploration costs whether successful

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[34]Horngren, "Marketing," p. 64.

[35]Kelly-Newton, p. 65.

or not, would be prohibited.[36] After the SEC had stated its intention to support the conclusions reached by the FASB in the exposure draft, the FASB issued Statement on Financial Accounting Standards No. 19.[37]

The elimination of the full-cost method was met with strong opposition by those oil and gas companies using it, mainly small independent firms. Reasons cited for the opposition were the ability of management to manipulate profits through the timing of exploration activities and the negative impact that the successful efforts method would have on earnings, reducing profits below what they would be under full-costing.[38] As a result, use of the successful efforts method was expected to inhibit the ability of small firms to raise capital, discourage exploration activities, and decrease competition in the industry.[39]

These allegations by oil and gas producers caused the Department of Energy to hold hearings to assess the impact of successful efforts on the U.S. energy supply and make a recommendation to the SEC. The claims that the prescribed method may be anticompetitive prompted the Department of Justice to request that the SEC hold hearings to find evidence to the contrary and

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[36] Ibid.

[37] Ibid., p. 66.

[38] Ibid.

[39] Ibid.

settle on the method that would be the least anticompetitive.[40]

The SEC yielded to the pressures exerted by the oil and gas companies and governmental agencies, and in August of 1978 issued ASR No. 253. The release stated that neither of the present methods was sufficient and proposed that a new method, reserve recognition accounting (RRA), was to be developed.[41] The proposed method was to be a current value method which required the recognition of oil and gas reserves as income when proved and exploration and development costs as expenses when incurred. The SEC stated that until RRA could be developed and the transition to the new method made, either successful efforts or full-costing would be acceptable.[42]

The result of the SEC's actions was two sets of accounting standards. ASR No. 253 allowed the publicly-traded companies to use either method while FASB Statement No. 19 required privately-held firms, including those small independent companies who voiced the loudest opposition, to use successful efforts. Auditors of publicly-held companies using the full-costing method would be required to qualify their audit opinions in compliance with the FASB statement even though the method was acceptable to the SEC.[43]

The FASB's solution to this conflict was to issue SFAS No. 25, which suspended indefinitely the effective date of SFAS

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[40] Ibid.

[41] Ibid.

[42] Ibid.

[43] Ibid., p. 67.

No. 19.[44] The fact that the FASB suspended SFAS No. 19 rather than repealing it may prove to be significant in light of recent events. Earlier this year the SEC stated that it no longer considers reserve recognition accounting to be a potential basis for the preparation of primary financial statements though it believes that RRA does still have merit for disclosure in supplemental information.[45] The SEC also went on to say that it would support the FASB in its effort to develop disclosure requirements for oil and gas companies.[46] It will be interesting to see what becomes of these developments.

The controversy over reporting by oil and gas industries exemplifies the position of the SEC over the FASB. Although the Commission tried to assure the FASB that its actions in this case were the exception rather than the rule and that the FASB would still retain its standard setting capabilities, the SEC reiterated its position of ultimate authority in ASR No. 253:

> The Commission's policy recognized that the FASB operates to establish accounting standards, but it does not involve a delegation of the Commission's substantive rulemaking authority to the FASB. While the Commission recognizes that,

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[44]Ibid., p. 68.

[45]Arthur Anderson & Co., "SEC Won't Require RRA by Oil and Gas Producing Companies," Accounting News Briefs 7 (April 1981): 2.

[46]Ibid.

> in general, it is most desirable for the private sector rather than the government to develop accounting standards, the Commission retains the final authority under the federal securities laws to promulgate rules, including financial accounting standards, that govern the preparation and presentation of financial statements issued by publicly owned companies, regardless of the FASB's determinations.[47]

It appears then, that although the Commission seems willing to let the FASB set accounting and reporting standards, it has the authority to override those promulgations and stands ready to exercise that authority should it perceive a need to do so. Thus maybe Horngren's analogy of a decentralized management subject to recentralization was fairly close.

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[47]U.S., Securities and Exchange Commission, Accounting Series Release No. 253, "Adoption of Requirements for Financial Accounting and Reporting Practices of Oil and Gas Producing Activities," SEC Docket 15 (September 12, 1978), p. 934.

CHAPTER V

GAINING ACCEPTANCE OF STANDARDS

As exemplified in the preceding chapter, the setting of accounting standards is not merely a matter of mechanics but involves gaining the support and acceptance of not only the SEC but the business community as well. Horngren describes this process of gaining acceptance as "marketing," which he defines as the "art of getting packages of ideas accepted by all affected parties in a professional manner."[48] In Horngren's view,

> ...the setting of accounting standards is as much a product of political action as of flawless logic or empirical findings. Why? Because the setting of standards is a social decision. Standards place restrictions on behavior; therefore, they must be accepted by the affected parties. Acceptance may be forced or voluntary or some of both. In a democratic society, getting acceptance is an exceedingly complicated process that requires skillful marketing in a political arena.[49]

In this chapter the political arena in which the FASB operates is discussed along with the reasons for management's reactions to proposed standards and the role of economic consequences in decision making.

The Political Framework

In any situation involving rule making, one person's improvement

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[48]Horngren, "Marketing," p. 61.

[49]Ibid.

is often another person's impairment. These trade-offs are the nucleus of policy making. However, those persons or entities who have been adversely affected are not likely to remain passive but will probably exert pressure on those with authority to change the rule.

Accounting policy formulation is no different. Consider again the example given in the preceding chapter of the oil and gas industry. The reasons given for the opposition included concern for the impact on the U.S. energy supply due to decreased exploration activities and the possibility that the method prescribed may be anti-competitive, both of which are largely economic and social concerns. Note, however, that those whose voices were the loudest, the small independent companies, had vested interests and would be adversely affected by the prescribed method.

Another incident is described by Marshall S. Armstrong, past chairman of the FASB.[50] The matter had to do with SFAS No. 5, "Accounting for Contingencies," in which it was concluded that casualty insurance companies could not accrue catastrophe reserves for a future catastrophe unless the loss could reasonably be estimated and it appeared probable that an asset had been impaired or a liability incurred. Shortly after the statement was issued, the FASB received a letter from a senator asking the basis for the FASB's conclusions and expressing concern on behalf of his

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[50] Marshall S. Armstrong, "The Politics of Establishing Accounting Standards," Statement in Quotes, The Journal of Accountancy 143 (February 1977): 77.

constituents that the Board had "acted with cavalier disregard for the fact that this Statement would wreck the American insurance industry and could result in an adverse balance of foreign exchange, spelling potential disaster for the American economy."[51] The FASB was able to satisfy the senator that it had not been reckless in its actions. Mr. Armstrong went on to speculate as to the underlying purpose of those who approach the legislature in cases such as this and wonder if their concern was really for the quality of American accounting as it was purported to be.[52]

The FASB must also beware that those whose voices are the loudest may not represent the majority's viewpoint. An analogy is drawn, again by Armstrong, to a quote from Edmund Burke's Reflection on the Revolution in France:

> Because half-a-dozen grasshoppers under a fern make the field ring with their important chink, whilst thousands of great cattle repose beneath the shadow of the British oak, chew the cud and are silent, pray do not imagine that those who make the noise are the only inhabitants of the field.[53]

The FASB must likewise be careful not to imagine that the "grasshoppers" whose noise is the loudest are "the only inhabitants of the field." Mr. Armstrong warns that:

> ...we are faced with a small but vocal minority, whose primary concern appears not to be with the

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[51]Ibid.

[52]Ibid., pp. 77-78.

[53]Ibid., p. 76.

> development of sound standards but, rather, with the protection of their own domains. And, we must constantly remind ourselves of this, lest we lose an awareness that this is the environment in which we are operating.[54]

The tendency on the part of industries to run to the government when they are dissatisfied with the FASB's promulgations has caused fears to be expressed by many that the government may eventually take control of the standard setting function. David Solomons, past president of the American Accounting Association, was one who expressed this fear:

> ...because standards need to be set mainly in areas where there is controversy, it is highly probable that in every case someone will find the new treatment less favorable than the status quo and there is constantly a temptation for such people to rush off to their legislative representatives to get the government to interfere. That sort of initiative represents the greatest threat on the horizon to the private control of standard setting.[55]

So, what if the standard setting function is taken over by the public sector? Horngren lists three possible results, which are: (1) enlightened governance which would be more clear-cut and less costly, (2) not much difference from the present, and (3) strangulating control with detailed, ponderous rules.[56] He then adds his opinion that the best to be hoped for would be "not

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[54]Ibid.

[55]David Solomons, "The Politicization of Accounting: The Impact of Politics on Accounting Standards," The Journal of Accountancy 146 (November 1978): 69.

[56]Horngren, "Will the FASB be Here in the 1980s?" p. 91.

much difference" though the possibility for strangulation does exist.[57]

How can the profession gain acceptance of its promulgations and thereby avoid a government takeover of accounting policy making? One possibility is by increased understanding of the reasons underlying management's reactions to the FASB's standards.

Factors Influencing Management's Reactions

Countless factors exist which influence the decision of management with regard to acceptance of proposed standards. Lauren Kelly-Newton, an accounting professor at the University of California, Los Angeles, identified four major categories: (1) the general resistance to change inherent in individuals and society, (2) the characteristics of the proposed change, (3) the communication channels through which the change is exposed, and (4) the social system effects of the change.[58]

The policy-maker must recognize that most individuals and society in general possess an inherent resistance to change, and the greater the perceived degree of change from the status quo, the greater the resistance to it. The result, then, is a slow incremental change process to gain acceptance of the standard.

The various aspects of a proposed change are also likely to affect management's reactions. Kelly-Newton lists five characteristics.[59] One is the advantages management perceives in implementing

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[57]Ibid.

[58]Kelly-Newton, pp. 90-108.

[59]Ibid., pp. 91-105.

the standard. These are often viewed in economic terms; that is, what it will cost management for the benefits expected to be derived. Another characteristic is the perceived compatibility of the proposed change with management's past experiences, values, attitudes, and needs. Greater consistency between the standard and these factors would result in increased likelihood of acceptance. This perceived compatibility may be influenced by management's attitude toward the policy maker based on past experiences in dealing with that particular body. Management's view of the complexity in understanding and implementing the change is a third aspect governing acceptance. This perceived difficulty in both comprehension and calculation is determined by management's technical skills, knowledge, education, and availability of outside consultants. Fourth is the trialability or extent to which a change may be implemented on a partial basis. Here again, the greater the magnitude of the change desired, the smaller the chance of acceptance. The final characteristic is the degree to which the consequences of adoption are foreseeable and communicated to management. Note that it is not as much a matter of the true characteristics of the proposed change as management's perceptions of these characteristics which influence the acceptance of the change.

The third general category identified by Kelly-Newton was that of communicating the proposed change. The channels used in the communication process may influence management's acceptance of the standard. If the channel is one to which management is accustomed, such as FASB Statements and SEC Accounting Series Releases, acceptance is much more likely than if a new channel is used. The clarity with which the information is explained may also be a factor. Confusing or ambiguous language may result in uncertainty on the part of management as to desired actions and results, which may in turn produce inaction or rejection.

The effect on the social system is the last identified category. Certain groups in society are viewed by others as trend setters or opinion leaders whose decisions have a wide influence on the opinions of others. In the business community one opinion leader is the management of companies who are leaders in their respective industries. Another is the public accounting profession whose advice on accounting matters is sought by their clients. In many cases, once an innovation has been accepted by these opinion leaders, support may well spread through other sectors of society.

Once these factors have been identified and understood, the policy-maker is faced with the task of dealing with them in attempting to gain acceptance of policies. Of course, some factors, such as the inherent resistance to change, are not within the control of the policy-maker. Others, like the communication factors, are easily overcome by the use of proper channels, clear wording, and complete examples. In between are those factors which may be influenced greatly by persuasion and education. One possible solution is an incremental approach, suggested by Dale L. Gerboth,[60] in which the policy-maker

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[60] Dale L. Gerboth, "'Muddling Through' with the APB," The Journal of Accountancy 133 (May 1972): 45-46.

strives for a series of small changes rather than attempting to implement a radically different change all at once.

Of course, one of the biggest factors affecting management's decision to accept or reject is the economic consequences of the proposed change; that is, how the change will affect a company's reported profits and the price of its securities, which in turn will affect the way management is viewed by those to whom it is responsible. Suggestions have been made for the FASB to initiate an economic impact analysis to determine the economic consequences of a standard before its issuance.

Economic Impact Analysis

Economic consequences have been defined as "the impact of accounting reports on the decision-making behavior of business, government, unions, investors, and creditors."[61] Prior to the 1970s, accounting was not considered to be responsible for economic effects. The CAP and APB for the most part appeared to resolve standard setting controversies in the light of traditional accounting, striving to produce "true" values rather than considering economic consequences. Recently, however, more emphasis has been placed on the economic consequences of accounting and reporting standards. The following reasons for this increased interest are part of a list cited by Stephen A. Zeff, professor of

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[61] Stephen A. Zeff, "The Rise of 'Economic Consequences,'" The Journal of Accountancy 146 (December 1978): 56.

accounting at Rice University, Houston, Texas:[62]

(1) the recent tendency of the American public to hold institutions responsible for the social, environmental, and economic consequences of their actions,

(2) the enormity of the impact on the level of earnings and other key financial figures and ratios of the issues being considered; for example, exploration and development costs of oil and gas companies, foreign currency fluctuations, and inflation,

(3) the increase in literature pertaining to the subject,

(4) investigations by Congressman John E. Moss and Senator Lee Metcalf into the performance of the accounting profession, including its standard setting function,

(5) the increasing importance of the earnings figure to management in raising capital, and

(6) the realization that outside parties could influence the setting of accounting standards.

The FASB has been informed that because no consideration was given to economic consequences, some standards have resulted in uneconomic behavior by management. For example, the requirement that research and development costs be expensed as incurred has allegedly discouraged research and development activities when such activities would be in the best interests of the company. Another example is that the standard requiring the recognition of foreign currency translation effects in the period of change in

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[62] Ibid., pp. 61-63.

exchange rates has caused companies to hedge foreign currency transactions even though doing so may not be the most economical for the company.[63] And of course, the well-worn example of the successful efforts method of accounting for oil and gas companies which would supposedly decrease exploration and development activities.

As a result of the increased emphasis on economic consequences, suggestions have been made that the FASB begin to analyze the economic impact of standards, before they are issued. One suggestion, by John W. Buckley, accounting professor at the University of California, Los Angeles, included a four-step process of impact analysis:

> 1. The social and/or economic objectives of a policy should be specified, ideally in quantitative terms.
>
> 2. The relationship of the policy to national goals and objectives should be specified, ideally in quantitative terms.
>
> 3. "Basic policy" should be distinguished from "pragmatic policy." All contingencies underlying the latter should be specified, e.g., short-term, interim, or state-of-the-art conditions.
>
> 4. There should be an assessment, ideally in quantitative terms, of the policy's impact across economic sectors (such as industries), and in relation to designated interest groups.[64]

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[63] Oscar S. Gellein, "The Task of the Standard Setter," Statement in Quotes, The Journal of Accountancy 146 (December 1978): 77.

[64] John W. Buckley, "The FASB and Impact Analysis," Management Accounting 56 (April 1976): 16.

If these suggestions are to be followed and economic impact analysis incorporated into the standard setting process, the FASB must recognize the problems involved in doing so. Arthur Wyatt of Arthur Andersen & Co. proposed a number of difficulties that the FASB should consider in attempting to add the consideration of economic consequences to its formal process.[65] According to Wyatt, the first consideration should be of the depth of research needed and the degree of quantification required in an analysis of economic impacts. Second, the qualification requirements for potential FASB members would need to be changed from the traditional expertise in accounting to require a much broader background. Third, the additional research required for evidence of potential economic consequences would cause increased time delays in the standard setting process, which has already been criticized for slowness. Fourth, the consideration of economic consequences creates the potential for increased confusion over the conclusions reached. Fifth, due to the "what if" nature of potential economic consequences, difficulties arise in obtaining real evidence on those consequences. And finally, even if hard evidence is obtained, the question remains as to how this information should be ranked and what effect it should have on the Board's decisions.

A number of different views have been expressed as to how the FASB's decisions should be influenced by economic impact information.

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[65] Arthur Wyatt, "The Economic Impact of Financial Accounting Standards," Statement in Quotes, The Journal of Accountancy 144 (October 1977): 93.

One view, alluded to in Buckley's comment above, is that the information should be used to formulate policies that are consistent with the government's economic goals. This view was expressed by Professor David Hawkins in a lecture given in New York:

> The (FASB's) objectives must be responsive to many more considerations than accounting theory or our notions of economically useful data... Corporate reporting standards should result in data that are useful for economic decisions provided that the standard is consistent with the national macro economic objectives and the economic programs designed to reach these goals... Because the (FASB) has the power to influence economic behavior it has an obligation to support the government's economic plans.[66]

The opposite view was expressed by Oscar S. Gellein, a former FASB member:

> ...we are told that financial statements should be designed to further national goals or economic policy. I am in complete disagreement with that role for financial reporting. Accounting standard setters should in my mind, guard zealously against designing financial reporting to influence behavior toward a specific economic end.[67]

He then went to to list several reasons for this view:

1. Standard setters are not competent either to make the value judgements required or to design the means to assure the end.

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[66] David M. Hawkins, "Financial Accounting, the Standards Board and Economic Development," one of the 1973-74 Emanuel Saxe Distinguished Lectures in Accounting, published by the Bernard M. Baruch College, City University of New York (April 1975), pp. 17, 9-11, cited by Solomons, p. 67.

[67] Gellein, p. 78.

2. They cannot foresee the rippling effects. They would be as likely to miss the goal as to hit it.

3. Financial reporting would need to be designed and redesigned repeatedly to keep up with changing goals.

4. Most significant, however, is the likelihood that financial reporting would lose its standing as a vital force in maintaining a healthy capital market.[68]

Upon conclusion of its study of the FASB's operations in 1977, the Financial Accounting Foundation recommended that an economic impact analysis be included in important exposure drafts but that the Board "need not be unduly influenced by the possibility of an economic impact, but it should consider both the possible costs and the expected benefits of a proposal."[69]

Regardless of the problems involved in economic impact analysis and its possible influence on decisions, it still has potential usefulness as an aid in gaining acceptance of standards in the business community:

> The standard setters need to be aware of these (economic and social) consequences so that they may avoid surprises as they resolve technical problems, anticipate opposition and strive for persuasive arguments to counter such opposition.[70]

It is apparent, then, from the preceding discussion that the FASB functions in a political arena in which it must go beyond the mechanical functions of standard setting to consider the social and economic impacts of its actions and market its promulgations in the business community.

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[68] Ibid.

[69] Financial Accounting Foundation structure committee, The Structure of Establishing Accounting Standards (Stamford, Conn.: FAF, 1977), p. 51, cited by Zeff, p. 61.

[70] Wyatt, p. 94.

CHAPTER VI

MODELS FOR POLICY FORMULATION

The mechanics of the standard setting process have previously been discussed in detail in Chapter III. To review briefly, the steps followed by the FASB consist of identification of the problem, appointment of a task force to study the problem, preparation and issuance of a neutral discussion memorandum outlining the issue and alternative solutions under consideration, a public hearing for oral and written comments, issuance of an exposure draft of the proposed rule for additional comment, and finally issuance of the standard itself.

Numerous views have been expressed on ways in which the process could be expanded to incorporate other factors proponents believe should be considered by the Board. This chapter discusses two particular views on possible policy making models held by two accounting academicians; Alfred Rappaport of Northwestern University, Evanston, Illinois, and Lauren Kelly-Newton of the University of California, Los Angeles.

Rappaport's Proposed Process

The process proposed by Rappaport is an expansion of the current sequence followed by the FASB to include a formal, explicit consideration of the economic consequences of a proposed standard.[71]

The first step proposed by Rappaport is not really a step at all but a continual process of environmental monitoring. The purpose of environmental monitoring would be to anticipate changes in the environment which may give rise to new accounting and reporting problems and may require issuance of a new standard. By anticipating problems, the Board may have more time for deliberations rather than attempting to promulgate standards when problems have reached the crisis point. Environmental monitoring, according to Rappaport, should include the

> ...continual monitoring of new developments in business practice, changes in government tax policy, changes in general economic conditions, shifts in social values that may have significant disclosure implications, technological change and other developments that could give rise to new measurement and disclosure issues.[72]

Rappaport suggests that the FASB may already have an organizational unit to perform the function. At present, the Task Force on Emerging Practice Problems performs the duties of reviewing requests to place a particular issue on the Board's agenda and making recommendations to the Board on the type of pronouncement required and the urgency of the problem. Rappaport's suggestion is that the

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[71]Alfred Rappaport, "Economic Impact of Accounting Standards -- Implications for the FASB," Statement in Quotes, The Journal of Accountancy 143 (May 1977): 96-97.

[72]Ibid., p. 96.

present duties of the task force be expanded to include the responsibility for environmental monitoring.

The task force would also be responsible for the next step of the process, a preliminary assessment of the emerging issues. Rappaport's views here parallel current practice with the addition of identification of economic consequences. In identifying economic consequences, consideration should be given to the industries or groups likely to be affected or claim adverse consequences of a proposed standard and the reasonableness of claimed consequences. By so doing, the Board could anticipate and assess the criticism likely to be encountered and include members of affected industries or interest groups on the task force which would prepare the discussion memorandum.

If, after the preliminary assessment, the FASB places the issue on its agenda, the next step is the appointment of a task force to prepare the discussion memorandum, again following present practice. Rappaport proposes, however, that the discussion memorandum go beyond the technical accounting aspects to include the anticipated economic consequences of each alternative solution. Responses to the discussion memorandum in written comments and public hearings could also go beyond technical accounting arguments to discuss further economic consequences not included in the discussion memorandum and disagreements or "errors" in the assessment of those consequences which are included. The advantages of presenting the potential economic consequences, according to Rappaport, would be to encourage critics to pull arguments into sharper focus and reduce the probability that an exposure draft or standard issued by the FASB would become so controversial as to threaten the Board's existence.[73]

As in present practice, issuance of an exposure draft of the proposed statement is the next step. Here again, Rappaport suggests inclusion of the anticipated economic consequences of each alternative and, in addition, a "cost-benefit statement" presenting the rationale for the Board's recommendations. Again feedback would be received and finally, the standard would be issued.

Rappaport's model closely follows the present process used by the FASB with the addition of formal procedures for considering the economic impact of proposed standards prior to their issuance. The model by Lauren Kelly-Newton is more comprehensive in that it considers other factors which may be relevant to the policy making process and goes beyond the issuance of the standard to monitor the results.

Kelly-Newton's Model

This model by Kelly-Newton emphasizes the factors to be considered in gaining acceptance of a proposed standard in the business community.[74] The first step parallels present practice in identifying the situation in need of change. Kelly-Newton comments that acceptance of a proposed change is enhanced by instilling the

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[73]Ibid., p. 97.

[74]Kelly-Newton, pp. 143-149.

need for the change within the business community.[75] which implies that communication between the policy maker and management should already begin in order to gain acceptance of the change.

The next step, according to Kelly-Newton, is acceptance by the business community of the FASB as the change agent. In other words, the business community must be persuaded that the FASB has the authority to deal with the issue and prescribe a solution. Disagreements with the SEC are seen here as lowering the credibility of the FASB and should be avoided if possible, perhaps by increased communication and coordination between the two groups.

Kelly-Newton suggests that the third step be to assess the outside views on the issue under consideration. In doing so, the FASB should take into consideration the factors influencing management's reactions to the proposed change, such as management's values and experiences. Two way communication is important here in which the proposed change is clearly presented and outside views are expressed to the FASB.

The model's fourth step involves assessing the potential consequences of the standard. This would enable the FASB to anticipate opposition to its issuance and prepare for it through persuasion and education of the business community.

Once the policy has been issued, Kelly-Newton recommends that the results of the new standard be monitored. This would enable the FASB to ascertain whether acceptance by the business community

[75]Ibid., p. 144.

is "behavioral" or "attitudinal." Attitudinal acceptance involves underlying approval of the change by management and is necessary for long-run acceptance. Behavioral acceptance means that management's behavior has been modified to comply with the standard but underlying approval has not been attained. Management then continues to oppose the change in one of two ways; either through criticism of the change itself or by challenging the policy maker who prescribed the change, often by approaching those with higher authority such as the SEC or Congress, resulting in a loss of credibility for the FASB.

Based on the monitored results, the final step in Kelly-Newton's model is the decision to retain, modify, or repeal the standard. If the standard is modified or revoked, the results are again monitored and the process repeated until a satisfactory solution is attained.

Implementation of Suggestions

One must realize that the foregoing discussion examines only two of the numerous models and suggestions as to the FASB's standard setting process, and it would be mere conjecture to determine which, if any, are better than others. The FASB has, however, begun to respond to some of these suggestions. Meetings of the FAF, the FASAC, task forces, and the FASB are now open to public observation. The FASB is also working to improve the communication of issues through simplified summaries of discussion memorandums and improved public hearing procedures. Most significantly the FASB recently announced a formal postenactment review of statements that have been in effect for at least two years. It is hoped that these and other changes will result in an increasingly efficient standard setting process.

CHAPTER VII

SUMMARY AND CONCLUSIONS

In summary, the emphasis on accounting policy formulation, as seen in its history, has undergone considerable change, from the self-regulation of companies in the 1920s through the formation of the SEC and private sector bodies, to the present Financial Accounting Standards Board, which together with the SEC, promulgates today's standards. The procedures followed by the two policy making groups differ widely; the FASB's formal process contrasted with the flexible informal procedures of the SEC.

Naturally, with two policy making groups, their relative power is bound to differ and conflicts arise. The SEC is seen as having the power to enforce its promulgations as well as the authority, prescribed by Congress, to make them. The FASB, on the other hand, has no such power, but must rely on persuasion of those affected by its standards and "allies" such as the SEC for support and enforcement. Of course, if that support is not forthcoming or if the FASB's standards are overridden by the SEC, the FASB has little choice but to modify its stand, as exemplified by the controversy over reporting by oil and gas companies.

Because it must rely on acceptance of its promulgations by affected parties, the FASB must consider a number of factors before issuing standards. The FASB must be sensitive to the fact that it is functioning in a political arena where those dissatisfied with its promulgations may seek help from higher authorities in modifying them. Therefore, the FASB must consider those factors influencing management's reactions to standards, such as management's values and past experiences. The FASB must also be aware of the economic consequences of its actions which may aid in anticipating opposition from management as well as enter into its decision making process.

Finally, two proposed models incorporating these factors were presented. The first emphasized the incorporation of economic consequences into the FASB's standard setting process. The second stressed the acceptance of the proposed change by affected parties at each step in the process and went on to recommend a procedure for monitoring the results of a standard following issuance. The FASB has begun to respond to some of the suggestions received.

In conclusion, the formulation of accounting policy is a complex process in which numerous political, economic, and conceptual factors interact. At present, the private sector appears to have the greatest responsibility for their promulgation although the SEC has overridden it on occasion. Fears have been expressed that the public sector will eventually take control of the standard setting function. Suggestions have been made, to which the FASB has begun to respond, which call for increased awareness beyond the technical accounting factors to include political and economic ones as well. As these factors are incorporated, policy making in the private sector should be strengthened.

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