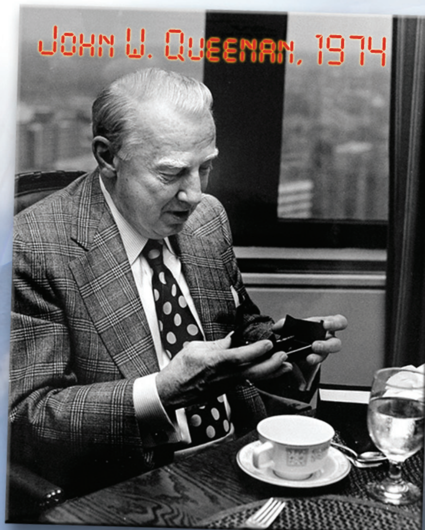
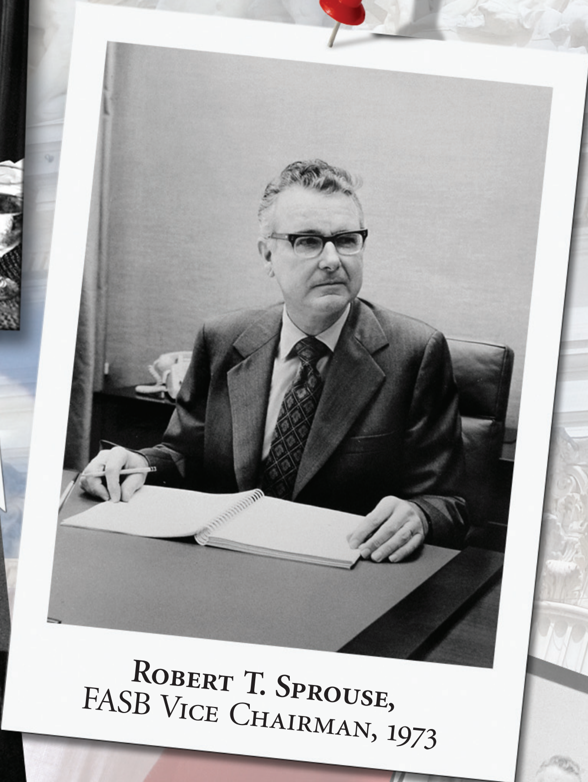
In Focus 75 YEARS

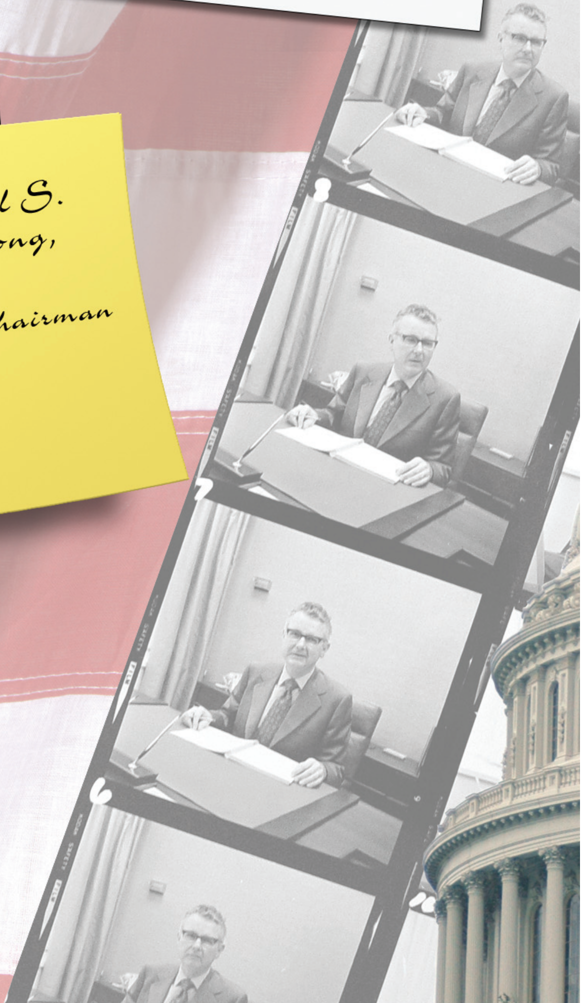




Robert T. Sprouse, FASB Vice Chairman, 1973

Ralph E. Kent, President of the Financial Accounting Foundation

Marshall S. Armstrong, FASB Chairman



Part 2: 1973–2004

Controversial Standards Trigger Special-Interest Lobbying

The Evolution of U.S. GAAP:

The Political Forces Behind Professional Standards

By Stephen A. Zeff

This article, the second of a two-part commentary about accounting standards setting, chronicles the rising importance of financial accounting standards in different sectors of the U.S. economy, which has led to increasing special-interest lobbying for accounting standards with characteristics compatible with the desired outcomes. Financial accounting standards affect the U.S. economy in many ways, both in the aggregate and in the distribution of income, wealth, and risk. This commentary captures many of the key issues that have preoccupied standards setters, and especially identifies the efforts of the Financial Accounting Standards Board to implement an asset-and-liability approach to recognition and a fair-value approach to measurement.

1973

The Financial Accounting Standards Board (FASB) succeeds the Accounting Principles Board (APB) on July 1, 1973, two days after the International Accounting Standards Committee (IASC) is formed. In 1969 and 1970, the Accounting Standards Steering Committee had been established in the United Kingdom and Ireland, replacing the program of the Institute of Chartered Accountants in England and Wales for issuing Recommendations on Accounting Principles.

Comment. In the early 1970s, the phrase "setting accounting standards" replaced "establishing accounting principles." The term "standards setter" came into vogue.

1973

Within the AICPA, the Accounting Standards Executive Committee (AcSEC), composed entirely of accounting practitioners, succeeds the APB. It issues Statements of Position (SOP) on accounting practices in specific industries.

Comment. This was the last preserve of the AICPA in the area of accounting standards setting, but the scope of this activity was narrow and Statements of Position were later subject to FASB approval before they could take effect. In 2002, FASB announces that, after a transition period, this work of AcSEC will be phased out.

1973

In Accounting Series Release 150, the SEC announces that it will look to FASB for leadership in setting accounting standards.

Comment. This was the SEC's first formal statement of support for a private-sector body setting accounting standards (or establishing accounting principles). Chief Accountant John C. (Sandy) Burton wanted the SEC to give FASB its full backing.

1973

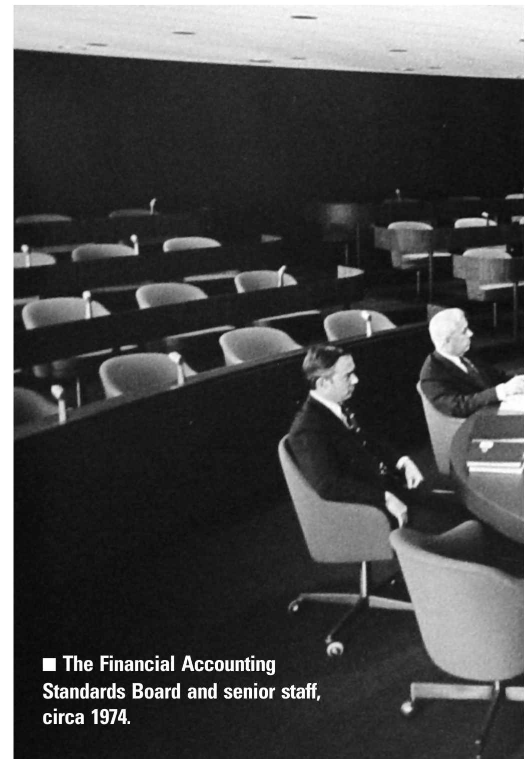
The Trueblood Study Group, created by the AICPA in 1971, issues a booklet, *Objectives of Financial Statements*, which advocates a "decision usefulness" approach to the development of accounting standards.

Comment. This was a milestone in the series of efforts by the accounting profession to establish a conceptual framework. Unlike the traditional emphasis on stewardship reporting, the Trueblood Study Group's approach was forward-looking: It said that an objective of financial statements is "to provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing, and related uncertainty." The group could not agree on whether value changes should be reflected in earnings, but it did provide a framework for thinking about the issue.

1974–1975

FASB unanimously issues Statement of Financial Accounting Standards (SFAS) 2, on accounting for research and development costs, and SFAS 5, on accounting for contingencies, which signal FASB's commitment to the primacy of the "asset-and-liability view" over the traditional "revenue-and-expense view." Under the asset-and-liability view, the definitions of assets and liabilities govern the recording of revenues and expenses, not the other way around, as under the matching principle.

Comment. FASB was troubled that the revenue-and-expense view perpetuated unintelligible balance sheet accounts that did not fit the definition of assets or liabilities, such as reserve for self-insurance and assorted deferred credits. Robert T. Sprouse, one of the original members of FASB, had written an article titled "Accounting for What-You-May-Call-Its" in the October 1966 issue of the *Journal of Accountancy* to elucidate this problem implicit in the revenue-and-expense view. The board concluded that the better approach was to agree first on whether a transaction had created an asset or liability and then determine the amount of any revenue or expense. This asset-and-liability view, which was to play a central role in FASB's conceptual framework, was foreshadowed in these two early standards.



■ The Financial Accounting Standards Board and senior staff, circa 1974.

1974, 1976, 1979

The 1970s are a decade of high inflation in the United States. FASB issues an exposure draft that would require companies to report price-level-adjusted information in supplementary statements. But in 1976, under the leadership of Chief Accountant Burton, the SEC issues Accounting Series Release 190, which requires approximately 1,300 large, publicly traded companies to disclose the effects of changing replacement costs, in

TIMELINE:

In its pursuit of conceptual goals, especially an asset-and-liability approach to recognition and a fair-value approach to measurement, FASB has generated opposition to financial accounting standards controversial issues. Special-interest lobbyists, working through Congress, have increasingly, and often successfully, influenced the standards-setting process, and there is no sign that this confrontational relationship will diminish.

1973

The Financial Accounting Standards Board (FASB) succeeds the Accounting Principles Board (APB) on July 1, 1973, two days after the International Accounting Standards Committee (IASC) is formed. FASB Chairman Marshall S. Armstrong, right. [1]

a supplementary disclosure. This rebuff embarrasses FASB, which in 1979 issues SFAS 33. It requires approximately 1,500 large companies to disclose the effects of both current cost and constant dollar information, in a supplementary format.

Comment. Here was evidence of the influence of the SEC's activist chief accountant. Burton could argue that his release dealt with disclosure, not with measurements appearing in the body of the financial statements. Yet Release 190 forced FASB's hand. Meanwhile, in the United Kingdom, the government's Sandilands Committee, whose members were drawn from outside the accounting profession, preferred current costs over the general price-level information favored by the profession's Accounting Standards Steering Committee. Because the government published general price-level indices, accounting numbers derived from them (known by FASB as constant dollar information) were easier to audit than current or replacement costs.

1975

The SEC's Division of Corporation Finance and Office of the Chief Accountant begin to issue Staff Accounting Bulletins (SAB), which represent the interpretations and practices followed by the Division and the Chief Accountant in administering the disclosure requirements of the federal securities laws. More than 100 SABs have been issued since.

Comment. This was a step, probably inspired by Chief Accountant Burton, to publicize the accounting views held by the SEC's staff without having to obtain the formal endorsement of the commissioners.

1975, 1981

By a vote of 6–1, FASB issues SFAS 8, on accounting for foreign currency translation, which requires that translation gains and losses be reflected in earnings. The standard induces some major companies to minimize their accounting exposure through hedging, thus risking economic exposure. Industry places pressure on FASB to revise the standard; this is achieved in 1981 by SFAS 52, which excludes certain translation adjustments from earnings, placing them instead in the shareholders' equity section of the balance sheet until the related transactions are consummated.

Comment. This was an example of accounting gains and losses not necessarily corresponding with economic gains and losses. To avoid the adverse economic effects of companies' hedging against their accounting gains and losses, as well as bending to the pressure from companies not to magnify the volatility of their earnings trends, FASB decided to remove the translation adjustments from earnings until the eventual completion of the related transactions. SFAS 52 was approved by a 4–3 vote; the dissenters disagreed with, among other things, the propriety of making direct entries in shareholders' equity. FASB's general dissatisfaction with classifying gains and losses as shareholders' equity gave rise to "comprehensive income" in the board's conceptual framework, a concept ultimately implemented as a standard in 1997.

1975

By a vote of 5–2, FASB issues SFAS 12, on accounting for marketable securities, which requires recognition in earnings of unrealized holding gains and losses on current marketable equity securities, but places in shareholders' equity such gains and losses on noncurrent marketable equity securities.

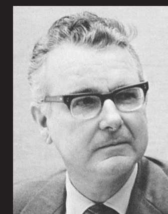
Comment. This was another area where accumulated gains and losses were parked in shareholders' equity instead of being included in earnings, even though the market prices of the securities were readily available. It revealed the board's reluctance to reflect upward revaluations of noncurrent assets in earnings.

1973

The Trueblood Study Group, created by the AICPA in 1971, issues a booklet, *Objectives of Financial Statements*, which advocates a "decision usefulness" approach to the development of accounting standards. [2]

1974–1975

SFAS 2 and SFAS 5 signal FASB's commitment to the primacy of the "asset-and-liability view" over the traditional "revenue-and-expense view." Robert T. Sprouse, one of the original members of FASB, had written in the October 1966 *Journal of Accountancy* about the problems implicit in the revenue-and-expense view.



1975–1981

Because of the Arab oil boycott and at a time of rising crude oil prices, Congress passes the Energy Policy and Conservation Act of 1975, which instructs the SEC to require all oil and gas companies to adopt the same accounting method instead of choosing between "successful efforts costing" and "full costing" in their financial statements. In 1977, by a 4–3 vote FASB issues SFAS 19, which allows only successful efforts costing. Small oil and gas producers, which had all been using full costing, protest vigorously and enlist support in Congress, the Departments of Energy and Justice, and the Federal Trade Commission. Finally, in 1978's Accounting Series Release 253, the SEC says it favors "reserve recognition accounting," a version of current value accounting. The major oil and gas producers object, and finally the SEC settles for a lengthy footnote disclosure. Oil and gas companies continue to use either successful efforts costing or full costing in their financial statements.

Comment. FASB felt rebuffed by the SEC's decision to propose a solution other than the one it had recommended. But SEC Chairman Harold M. Williams pointed out that this had been a unique case, where the SEC had been expressly charged by Congress to find a solution. Apart from Accounting Series Release 190 on replacement cost accounting (discussed above), this was the only instance in which the SEC overruled FASB on a substantive accounting issue.

It is a matter of interest that the SEC's decision was formulated by the commissioners themselves, and not by the SEC's accounting staff. The commissioners had become actively engaged in the accounting issue—something that rarely occurs—because of the intense political lobbying by the powerful oil and gas industry, which secured the eager support of members of Congress from oil-producing states. To nonaccountants, historical cost accounting is not a solution that responds to the information needs of investors and creditors. The Sandilands Committee, mentioned above, had earlier arrived at a similar result. Historical cost accounting is a construct understood by accountants and a puzzle to nonaccountants, who typically believe that current market value is more relevant for investors and creditors.

Concerned about their ability to obtain bank financing, small and medium-sized oil and gas exploration companies had resisted successful efforts costing, because it would make their earnings trend more volatile and, in the near term, vastly lower their earnings. The Energy Department did not like successful efforts costing because the exploration companies' more volatile earnings would be a disincentive to explore in untried fields. The Justice Department, together with the Federal Trade Commission, feared that successful efforts costing by small and medium-sized exploration companies would lead to bleak earnings pictures that might drive them into mergers with the big companies, thus reducing the number of competitors in the industry. These were all political reasons, not accounting reasons, and after hearing all of the arguments, the SEC commissioners favored current value accounting instead of either version of historical cost accounting.

After the SEC proposed requiring oil and gas companies to report the gains from the increase in market value of their proved reserves in their income statements—gains, because the OPEC cartel was regularly raising the price of crude—the American public, which was already concerned about the rising price and scarcity of fuel, had risen in wrath against the oil industry. The last thing that the major oil and gas companies (Exxon, Mobil, Gulf, Shell) wanted to report was even higher accounting earnings, because of their concern over the appearance of gouging the public.

In the end, the SEC withdrew the proposed requirement to record current values in the financial statements of oil and gas companies and instead instructed FASB to issue a standard (which became SFAS 69, approved 4–3 in 1982) that would specify "a comprehensive package of disclosures for those engaged in oil and gas producing activities," reflecting current values. The oil and gas industry had weathered the storm; as before, some companies were using successful efforts costing, while others were using full costing. Historical costs continued to be used in the body of the companies' financial statements.

1976

After considerable pressure from the leasing industry, FASB issues SFAS 13, approved 5–1, establishing the capitalization of long-term financing leases on lessees' books. The standard is amended numerous times as FASB seeks to close loopholes, yet SFAS 13 nonetheless proves to be ineffective in requiring that most long-term leases be capitalized.

Comment. Because of the resourcefulness of the leasing industry in finding loopholes in SFAS 13, this became the most frequently amended accounting standard. It demonstrated that a standards setter should not establish explicit, arbitrary cutoff percentages, because companies seeking to circumvent the intent of the standard will inevitably find ways to do so. It may be the best example of a rule-based standard that fails to specify a guiding principle.

1975

The SEC's Division of Corporation Finance and Office of the Chief Accountant (led by John C. (Sandy) Burton, left) begin to issue Staff Accounting Bulletins, which represent the interpretations and practices followed in administering the disclosure requirements of the federal securities laws.[3]

1975

FASB issues SFAS 12, on accounting for marketable securities. This was another area where accumulated gains and losses were parked in shareholders' equity instead of being included in earnings, even though market prices were readily available.

1976–1977

Two Congressional reports recommend that the SEC no longer rely on FASB for accounting standards but instead issue the standards itself.

Comment. The reports were issued by the staff of the Senate's Metcalf Committee and by the House's Moss Committee. The issue of public-sector versus private-sector standards setting was raised in these reports, but, in the end, no Congressional action was taken on these recommendations.

1977

By a 5–2 vote, FASB issues SFAS 15, on accounting by debtors and creditors for troubled debt restructurings, which, in effect, allows financial institutions that agree with debtors to modify the terms of their long-term loan agreements (lengthening the term and reducing the interest rate) to avoid recording a loss on the restructuring. The banking industry argued that a requirement to recognize a loss in such circumstances would lead to reluctance by banks to renegotiate such loans, thus leading to a higher rate of business failure.

Comment. In 1973, the City of New York was said to be bankrupt, and, with great difficulty, the banks that held the city's debt instruments restructured the debt by modifying its terms. The principal payments were postponed, and the interest rate on the debt was lowered. The banks proposed not to reduce the balance on their books of the loan receivable from the city and therefore not to recognize any immediate accounting loss. FASB began to study the question, and the possibility of recognizing a loss in the event of such restructurings was put to a public hearing. At the hearing, Citicorp Chairman Walter B. Wriston said that if the banks had known that they might be required to recognize an immediate accounting loss from restructuring the city's debt, "the restructuring just might not have happened." Furthermore, the prospect of a required recognition of a loss in such cases led Wriston to doubt that such restructurings would be possible in the future. His bombshell testimony put considerable pressure on FASB. In the end, the board said in SFAS 15 that if, after a restructuring, the total cash flows to be received under the new terms were no lower than the balance in the receivable account, no writedown or loss recognition would be required. The standard was heavily criticized because it ignored the economic reality of the transaction altogether.

Application of SFAS 15 also prolonged and deepened the financial crisis faced by banks and savings and loan institutions in the 1980s. Many banks and thrift institutions effectively became insolvent because of many bad loans, especially at a time of high interest rates. Federal regulators allowed them not to record writedowns or recognize losses after they had restructured loans to accommodate the debtors. Hence, many of these financial institutions could issue balance sheets projecting an apparent solvency, when many should have been closed. SFAS 15 was used by regulators to justify this policy. As a result, the standard was said by many to be the worst ever issued by FASB.

1977

Responding to criticisms from within the accounting profession, the Financial Accounting Foundation's (FAF) trustees strengthen FASB's due-process procedures and impose a 4–3 majority, instead of a supermajority of 5–2, to approve its standards. It was believed that the required 5–2 majority was holding back FASB approval of several standards (notably SFASs 19 and 34). The board also opens its meetings to public observation.

1978–1985

FASB issues its Concepts Statements on objectives, qualitative characteristics, elements (definitions), and recognition and measurement, constituting its conceptual framework for business enterprises. As the issues become more specific, eventually dealing with the sensitive and practical matters of recognition and measurement, the board can agree only to be general and not prescriptive. This reflects the fact that each of the board members has an individual conceptual framework, which becomes evident when the core issues of recognition and measurement are taken up. The result of the board's conceptual framework discourages those who had hoped that it would point the board toward a resolution of its most difficult standards issues.

Comment. Although there was no suggestion in the Wheat Study Group's report that FASB should develop a conceptual framework, the board discovered that several of the early standards—for example, on research and development costs and contingencies—required it to define assets and liabilities more clearly. Furthermore, the Trueblood Study Group's booklet, *Objectives of Financial Statements*, was available as the first layer of such a framework.

The conceptual framework became a massive project. Between 1974 and 1985, the board issued 30 discussion memoranda, research reports, exposure drafts, and other publications, totaling over 3,000 pages. The first Concepts Statement, *Objectives of Financial Reporting by Business Enterprises*, was published in 1978. The second, *Qualitative Characteristics of Accounting Information*, published in 1980, was widely imitated in other countries.

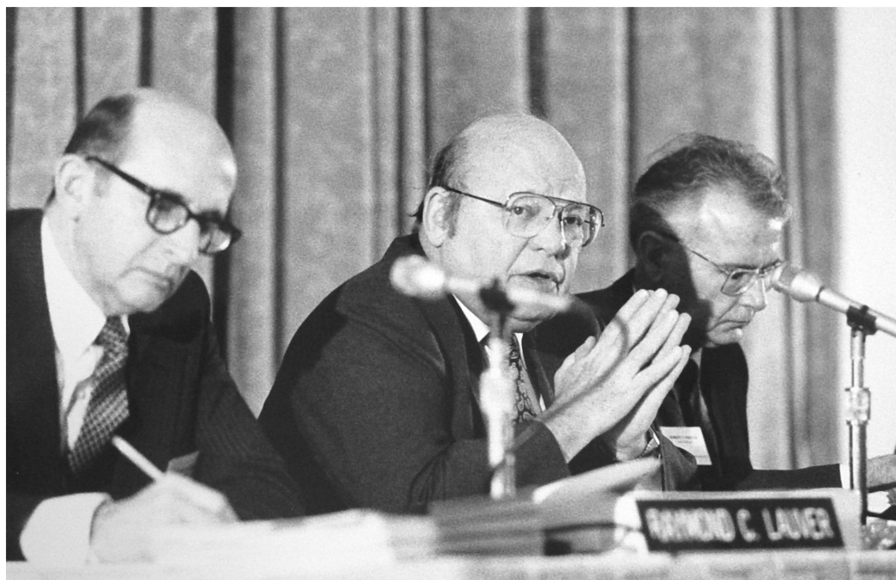
The series of Concepts Statements proved useful to the board when facing novel accounting questions. The board wanted to

1975–1981

In 1975, Congress instructs the SEC to require all oil and gas companies to adopt the same accounting method instead of choosing between "successful efforts costing" and "full costing." In 1977, SFAS 19 requires successful efforts costing. Small oil and gas producers protest vigorously and enlist political support. In 1978's Accounting Series Release 253, the SEC favors "reserve recognition accounting," a version of current value accounting. Large oil and gas producers object, and finally the SEC settles for footnote disclosure. Oil and gas companies may continue to use either method. FASB was embarrassed by the SEC's decision to propose a different solution. SEC Chairman Harold M. Williams called it a unique case, where the SEC had been expressly charged by Congress to find a solution.

be guided by principle wherever possible, and the framework contributed toward that end. But it became evident that a considerable amount of reasoning was needed to connect the framework with the specific accounting problems to be solved.

FASB was a pioneer in that it was the first accounting standards setter in the world to complete work on a full-fledged conceptual framework. Since then, the standards setters in Australia, Canada, the United Kingdom, and New Zealand, as well as the International Accounting Standards Board, have borrowed ideas from FASB's framework. In later years, FASB has revisited the framework, for example by issuing a Concepts Statement in 2000 on cash flow information and present values in accounting measurements. In October 2004, FASB and the International Accounting Standards Board agreed to develop a common conceptual framework, building on the two bodies' respective frameworks.



■ **FASB member John March, Pensions Public Hearing, 1984**

1979

By a 4–3 vote, FASB issues SFAS 34, requiring that companies capitalize interest cost for certain self-constructed assets. The standard is issued to correct an abuse. In 1974, at a time of rising inflation and interest rates, a number of companies had been capitalizing, rather than expensing, their interest cost, so as to report higher earnings. At this time, the SEC immediately placed a moratorium on this practice until FASB could decide whether it was a proper accounting practice.

Comment. The capitalization of the cost of interest had not been practiced in the United States other than in the public utility industry, where the rate of return on investment was used by regulators to set prices. In that industry, the interest cost incurred to expand plant capacity was intentionally charged to future generations of users through capitalization and then amortization when the new capacity went into service. To expense the cost of interest would, in effect, charge current users for the interest cost to build future capacity.

The matter had not previously been the subject of an accounting standard anywhere in the world, and there was no prohibition against capitalizing the cost of interest. Five years after the SEC, fearing that these companies' financial statements might be misleading to investors and creditors, placed a moratorium on the practice, FASB issued its standard on the subject. In SFAS 34, it narrowly defined the classes of assets on which interest could be capitalized.

1985, 1987, 1990, 1996

On four occasions, as the flexibility to produce favorable earnings grows in importance to CEOs, industry places pressure on FASB to be more responsive to its objections. Attempts are made to expand the number of industry representatives on the FASB board and to exercise more control over its agenda. In 1990, industry persuades the FAE trustees to raise the majority required to approve standards from 4–3 to 5–2, hoping to slow the pace of standards setting. In 1996, SEC Chairman Arthur Levitt, reacting to further pressure from the Financial Executives Institute (FEI), forces the FAF to add four public interest members to its board of trustees.

Comment. This series of interventions from industry epitomized the higher stakes that companies placed on the flexibility to choose their preferred accounting methods. The 1980s was a period of intense merger and acquisition activity, and CEOs as well

1976

After considerable pressure from the leasing industry, FASB issues SFAS 13, approved 5–1, establishing the capitalization of long-term financing leases on lessees' books. The standard is amended numerous times, but SFAS 13 nonetheless proves to be ineffective in requiring that most long-term leases be capitalized.

1977

SFAS 15 allows financial institutions to avoid recording a loss when they restructure the terms of long-term loan agreements (lengthening the term and reducing the interest rate) . SFAS 15 eventually serves as a basis by which government prolonged and deepened the 1980s savings-and-loan crisis. The standard is said to be the worst ever issued by FASB.

as CFOs began to pay close attention to FASB's proposals to disallow certain accounting methods, impose additional disclosures, and specify in greater detail how its standards were to be interpreted. As companies increasingly based annual bonuses on accounting earnings, and increasingly turned to employee stock options, executives became more sensitive to how earnings were measured. In the 1990s, it became common for financial analysts to issue earnings forecasts, and company executives knew that their share price would suffer if they reported earnings-per-share below the forecast. All of these pressures were in turn transmitted to FASB, and industry sought to have more influence over the actions of the standards setter. Of course, the SEC would continue to enforce FASB's standards strictly, imposing heavy penalties for noncompliance.

At the same time, top corporate executives transmitted these pressures to their accounting departments and from there to their external auditors, which is one explanation of the willingness of auditors to accede to the marginal and even illicit accounting practices that have come to be known as "managed earnings."

While industry enjoyed a few successes in influencing the composition and operating procedures of FASB, the SEC intervened to protect the independence of the board, especially in 1987 and 1996, when the Business Roundtable and FEI, respectively, sought to exert more industry control over the operation and governance of FASB.

1985

By a 4–3 vote, FASB issues SFAS 87, on employers' accounting for pension plans, after 11 years of study on the large and complicated subject of pension accounting, comprising three discussion memoranda, six exposure drafts, four public hearings, and six standards. While it represents an improvement in pension accounting practice, it significantly understates the full accounting impact of company pension plans by a variety of smoothing rules and an extended adoption period. Also, the standard appears at a time of strong stock and bond markets. Industry had successfully lobbied FASB to dampen the effect of volatility on companies' earnings as a result of market value fluctuations.

Comment. This was a sensitive subject that had been followed closely by the Business Roundtable since the 1970s. It was especially critical to companies in older industries, such as automobiles and steel. Once again, companies pressed FASB not to heighten the volatility of earnings.

1987

By a 6–1 vote, FASB issues SFAS 94, which requires parent companies to consolidate subsidiaries with nonhomogeneous operations, such as the finance subsidiaries of manufacturing parents. FASB also endorses the notion of control for determining when investee companies should be consolidated, but the board puts off implementation. It makes several attempts to implement it in the 1990s, but cannot agree on an adequate and workable approach for doing so.

Comment. Companies were concerned that the consolidation of industrial parent companies with their finance subsidiaries (e.g., General Motors, Ford, and General Electric) would confuse readers about the debt-equity ratio of the industrial parent. Finance companies are much more heavily leveraged than industrial companies, and industry preferred that their financial statements not be merged. General Electric has responded by publishing three sets of financial statements in its annual report to shareholders: the consolidated statements, the parent company statements, and the finance subsidiary's statements.

1987

By a 4–3 vote, FASB issues SFAS 95, which requires companies to publish a cash flow statement, replacing the Statement of Changes in Financial Position (funds statement). The standard implements a recommendation in Concepts Statement 5, on recognition and measurement. FASB allows companies to use either the direct or the indirect method of presentation.

Comment. The cash flow statement replaced the Statement of Changes in Financial Position, a funds flow statement, reflecting a worldwide trend. Standards requiring cash flow statements were issued in Australia in 1983 and in Canada in 1985; hence, on this subject, FASB was not in the vanguard.

1987–1992

By a 5–2 vote, FASB issues SFAS 96, which establishes an asset-and-liability approach for determining deferred tax liabilities, but prohibits the recognition of tax benefits expected to be realized in future years. Shortly after its issuance, FASB concludes that the standard is unworkable and too complex, and it postpones the effective date of SFAS 96 three times. Finally, in 1992, FASB unanimously issues SFAS 109, which allows deferred tax assets to be recognized in many situations.

Comment. This was one of the best examples of how the asset-and-liability view led to a more defensible standard.

1990

FASB unanimously issues SFAS 106, on accounting for postretirement health-care costs. This standard was strongly opposed by industry because companies did not want to show a liability for the contractual commitments they had given over the years to cover retired-employee health-care. General Motors recognizes a first-time expense and liability

1985

After many years of studying pension accounting, FASB issues SFAS 87, on employers' accounting for pension plans. While it represents an improvement, it understates the full impact of company pension plans by smoothing rules and an extended adoption period. Companies had successfully lobbied FASB to dampen the effect of volatility on companies' earnings as a result of market value fluctuations.

1987

SFAS 95 requires companies to publish a cash flow statement, implementing a recommendation in Concepts Statement 5. FASB allows companies to use either the direct or indirect method of presentation. The cash flow statement replaced the Statement of Changes in Financial Position, a funds flow statement, reflecting a trend occurring around the world.

of $20.8 billion, which constituted 77% percent of its shareholders' equity at the end of the previous year. The shareholders' equity balances of Chrysler, Ford Motor, AT&T, and IBM are also hit hard by the newly recognized liability. Many regard SFAS 106 as the best standard FASB ever issued, as it forces companies to face the true cost of their future obligations for health-care benefits granted to employees. It gives rise to the maxim "You manage what you measure."

Comment. Industry intensely disliked this standard and fought against it; afterwards, companies conceded its constructive effect on their decision making. It is an excellent example of how a standard can have a considerable impact on corporate behavior. SFAS 106 has been one of the board's successes.

1993

By a 5–2 vote, FASB issues SFAS 115, on accounting for investments in certain equity and debt securities. Although the SEC argues strongly for fair value accounting, with all gains and losses recognized in earnings, the banking industry vociferously opposes this solution because of the resulting earnings volatility. A political compromise is thus forced on the board to recognize "trading securities" and "available for sale securities." Both would be on the balance sheet at fair value, but the unrealized gains and losses on "available for sale securities" would be parked in shareholders' equity, and not be taken to earnings.

Comment. This standard was a revision of SFAS 12, which distinguished between current and noncurrent investments in securities. This reconsideration began in earnest when SEC Chairman Richard C. Breeden made it known in 1990 that he favored the use of current value accounting for marketable securities held by banks and thrift institutions. The SEC was an unusual source for the advocacy of current value, or fair value, accounting in company financial statements, as it had strongly asserted the propriety of having financial statements prepared on the basis of historical cost accounting since its founding in 1934 (the lone exception being reserve recognition accounting for oil and gas producers in 1978). This marked the beginning of the SEC's more yielding position toward fair value accounting in the 1990s, especially for financial instruments.

As the board moved in the direction of a current-value standard, with the gains and losses taken into the income statement, the banking industry, including Secretary of the Treasury Nicholas Brady and Federal Reserve Board Chairman Alan Greenspan, protested vigorously. Congress also became involved. Their concern was not only over the volatility of earnings that the standard would create, but also over its possible effect on credit availability and the perceived financial stability of the country's banking sector. The board's political solution allowed gains and losses accruing on securities most likely to have large gains and losses (i.e., those designated as available for sale securities) to be buried in shareholders' equity, while the more modest gains and losses on trading securities (i.e., ones likely to be disposed of very soon) would be shown in the income statement.

1995

In another application of fair value accounting, by a 5–2 vote FASB issues SFAS 121; it requires companies to recognize the impaired values of assets but, at the same time, stops them from over-accruing provisions (i.e., "big bath" charges) that would artificially ensure larger reported profits in the future. SFAS 121 (which is superseded in 2001 by SFAS 144) provides a series of decision rules for such writedowns, including the fair value of the impaired assets or, in the absence of a determinable fair value, the present value of future expected cash flows.

Comment. SFAS 121 addressed a problem that had attracted considerable attention in the 1980s, when some companies were thought to have exaggerated the amounts of their impairment writedowns in order to project a rosy future. The market ignored massive writedowns in such circumstances, because it was interested only in future prospects, and the companies took full advantage of this tactic. The purpose of the standard, which represented another step in the direction of fair value accounting, was to impose some discipline on companies recording impairment writedowns. As with many of FASB's standards, there were no precedents in other countries on which to build.

1995

By a 5–2 vote, FASB issues SFAS 123, on accounting for employee stock options. This standard also involves an estimate of fair value, through the use of option-pricing models. But an unprecedented political lobbying campaign by small, high-technology companies secures the active support of Congress and prevents FASB from requiring the recognition of the stock option expense in companies' income statements. Instead, the amount of the expense for options recently granted is to be disclosed only in a footnote to the financial statements.

Comment. The run-up to SFAS 123 was one of the best-known examples of political pressure on FASB, including strong influence exerted by Congress. Had FASB persisted in issuing a standard requiring the expensing of options, Congress might have passed legislation putting FASB, in effect, out of business. By the early 1990s, the awarding of

1990

FASB issues SFAS 106, on accounting for postretirement health-care costs. This standard was strongly opposed by industry because companies did not want to show a liability for retired-employee health-care commitments. General Motors recognized a first-time expense and liability of $20.8 billion; Chrysler, Ford Motor, AT&T, and IBM were also hit hard. Many regard SFAS 106 as the best standard FASB ever issued, as it forced companies to face up to the true cost of their obligations for health-care benefits granted to employees over many years.

employee stock options to corporate executives and, often in the high-tech industry, to all employees, had burgeoned. The last previous standard on the subject, issued by the APB in 1972, had antedated the development of option-pricing models and said simply that no compensation expense was to be recorded unless the market price of the shares under the option was greater than the exercise price. For income tax reasons, the exercise price was always set to equal the market price; hence, no compensation expense would be recorded. Most observers considered that such stock option compensation was not devoid of cost.

Taking advantage of the literature on option-pricing models, FASB began developing a standard that would require companies to expense the fair value of the stock options granted to executives and other employees. The reaction from industry was swift and categorical: It was opposed to any such standard ever taking effect. FASB Chairman Dennis Beresford confessed that he had never seen a more livid reaction from CEOs to a proposed FASB standard. A standard on the expensing of stock options would directly affect their personal compensation packages, because shareholders would criticize the company when its grants of stock options began depressing the company's reported earnings.

Even stronger objections came from the high-technology industry, especially companies based in Silicon Valley. Many of them had been reporting no earnings at all, and they feared that expensing stock options would greatly increase their losses or remove whatever earnings they might ever report. When it became evident that FASB was determined to proceed with the standard, they appealed to members of Congress, claiming that the standard would threaten high-tech entrepreneurship. Members of Congress can react in several ways: write letters to FASB (which usually are ineffective); hold public hearings and ask FASB to defend itself before a hostile audience; or introduce legislation that would order the SEC not to enforce a proposed standard.

While some members of Congress favored FASB's proposed option-expensing standard, a much larger number, under pressure from corporate political contributors, adamantly opposed it. Proposed legislation was introduced in both the House and the Senate, either ordering the SEC to enforce FASB's eventual standard or ordering the SEC not to enforce it. FASB held public hearings on the East and West Coasts; the hearing on the West Coast, on the edge of Silicon Valley, was accompanied by a raucous protest rally in a nearby convention hall attended by thousands of high-tech company employees who had been given half a day off from work to sign petitions to the President and speak out against FASB.

As FASB proceeded toward issuing a standard, the "attack mentality" on Capitol Hill intensified. The Senate passed a resolution, 88–9, urging FASB not to move ahead with its standard. Then one Senator, Joseph Lieberman (Democrat of Connecticut), introduced a bill that would have required the SEC to hold a public hearing and cast a vote on each future standard issued by FASB, which would, in effect, have led to the board's demise. At that point, SEC Chairman Arthur Levitt, who had been on record as strongly favoring FASB's proposed standard, counseled FASB not to mandate options expensing, because the board's future existence might be at risk. Several years later, Levitt confessed that this advice to FASB was the biggest mistake he made during his tenure.

Heeding the SEC Chairman and the warnings from Capitol Hill, FASB instead issued a standard that required footnote disclosure of the amount of the expense associated with stock options, with an indication of the impact on earnings per share. The board encouraged companies to include the expense in their income statement, but only a few did so.

In recent years, owing to public pressures arising from the Enron and WorldCom scandals, more than 825 listed companies—about 120 of them included in the Standard & Poor's 500—have begun recording the stock option expense in their income statement or have announced that they will soon begin doing so.

1997

By a 5–2 vote, FASB issues SFAS 130, on the reporting of comprehensive income, which will include those gains and losses not yet recognized in earnings. It proposes this disclosure in either a separate statement of comprehensive income or an additional section in the income statement. Industry, however, successfully lobbies FASB to offer a third alternative: disclosure in the Statement of Changes in Shareholders' Equity, a statement that financial statement readers seldom examine carefully. The final standard includes all three alternatives, yet most companies have opted to park other comprehensive income in the Statement of Changes in Shareholders' Equity.

Comment. In a follow-up to Concept Statement 3, this standard was an attempt by FASB to give greater prominence to the gains and losses from foreign exchange translation and marketable securities that had been relegated to shareholders' equity. They were to be described as "other comprehensive income." But the FEI pressured FASB to allow the other comprehensive income to be reflected in a statement that few financial statement readers notice.

1997

Amazon.com begins a practice, soon to be adopted by other high-technology companies, of emphasizing "pro forma income,"

1995

FASB issues SFAS 121, requiring companies to recognize the impaired values of assets while stopping them from overaccruing provisions (i.e., "big bath") that would artificially ensure larger reported profits in the future. SFAS 121 (superseded by SFAS 144) provides a series of decision rules for such write-downs, including the fair value of the impaired assets.

1995

SFAS 123, on accounting for employee stock options, is blocked by an unprecedented lobbying campaign by high-technology companies. This is one of the best-known examples of Congressional pressure on FASB. SEC Chairman Arthur Levitt counseled FASB not to mandate options expensing, because the board's existence might be at risk.

by which certain negative items, such as goodwill amortization and impairment charges, are placed below the line, although they are necessarily included in GAAP earnings. SEC Chief Accountant Michael Sutton and others criticize this practice of emphasizing the positive and deemphasizing the negative in pro forma income, thus biasing a company's reporting. The Sarbanes-Oxley Act of 2002 requires that any such pro forma income be explicitly and prominently reconciled to GAAP earnings.

Comment. This was a further attempt by industry, especially the high-tech sector, to manage earnings by focusing readers' attention on the good news. One observer described this practice as showing "earnings before the bad stuff."

1998

FASB unanimously issues SFAS 133, on accounting for derivative instruments and hedging activities. Industry had fought hard against FASB's fair-value proposals in the standard. Legislation had been introduced in both the Senate and the House, and committees had held hearings to persuade FASB to back down. In the end, FASB successfully issues a fairly strong standard on an enormously complex subject.

Comment. As always, fair value accounting was a highly sensitive subject, and SFAS 133 expanded its use.

2002

By unanimous votes, FASB issues SFAS 141, on accounting for business combinations, and SFAS 142, on accounting for goodwill and other intangibles. The staff of the SEC's Office of the Chief Accountant, complaining that 40% of its time is spent on the business combinations issue, persuades FASB to add the subjects to its agenda. For some time, FASB had wanted to ban the pooling-of-interests treatment of business combinations, which had been seriously abused by acquisition-minded companies. In its exposure draft, FASB resolves to disallow pooling of interests and to reduce the maximum life for amortizing goodwill and other intangibles to 20 years (from 40 years, per 1970's APB Opinion 17). Industry objects strongly to these proposals, especially the required amortization of goodwill, and persuades Congress to intervene. Ultimately, SFAS 141 disallows use of the pooling-of-interests method, and SFAS 142 imposes a mandatory annual impairment test for goodwill and disallows amortization. Under SFAS 142, other intangible assets may be amortized or be made subject to an annual impairment test.

Comment. This began as an attempt by FASB to converge with the international standard on the treatment of goodwill. While members of Congress did force FASB to consider an impairment test for goodwill, instead of mandatory amortization, the board concluded that it could accept an impairment test as a matter of principle, and it went ahead accordingly.

Ironically, because of the depressed economic conditions following the approval of SFAS 142, quite a few companies had to reduce their earnings by much more when applying the mandatory annual impairment test for goodwill than they would have recorded by amortizing goodwill over a 20-year period.

The elimination, at long last, of the pooling-of-interests method to record mergers was a triumph for FASB.

■ **The Securities and Exchange Commission with Division Directors and Office Heads, 1995.**

1996

SEC Chairman Arthur Levitt, reacting to further pressure from FEI, forces the FAF to add four public interest members to its board of trustees. The SEC intervened to protect the independence of the board when industry sought to exert more control over operation and governance.

1997

Amazon.com emphasizes "pro forma income," placing certain negative items below the line. SEC Chief Accountant Michael Sutton and others criticize this practice as biasing a company's reporting. The Sarbanes-Oxley Act of 2002 requires pro forma income be prominently and explicity reconciled to GAAP.

2002–2003

The Sarbanes-Oxley Act of 2002 (SOA) requires that FASB be financed henceforth by fees assessed against publicly traded companies, instead of by donations from the private sector. The purpose of this change is to enhance FASB's independence. SOA also charges the SEC with designating a private-sector standards setter that meets the criteria for establishing accounting principles that are to be regarded as generally accepted for purposes of the securities laws. In April 2003, the SEC announces that it will continue to recognize FASB pronouncements as generally accepted.

SOA instructs the SEC to study the merit of principles-based accounting standards, in contrast to the traditional emphasis in the United States on rule-based standards. Both FASB and the SEC respond positively, but it is the SEC's accounting staff that had traditionally pressed FASB to issue more and more detailed rules. The highly litigious environment in the United States is another reason accounting standards had become detail-oriented.

Comment. FASB is likely to emphasize principles and objectives in its forthcoming standards, but it remains to be seen whether its standards will become shorter and less detailed. There is no sign that the SEC accounting staff is becoming less insistent on company compliance with detailed norms. The accounting culture in the United States is one of highly specific and prescriptive standards, and a change in culture is not simple to achieve.

2004

FASB issues an exposure draft to converge with the International Accounting Standards Board's IFRS 2, on share-based payments. As in the 1993/1994 debate, the high-technology sector vigorously opposes a required expensing of employee stock options in the income statement, and engages the strong support of more than 300 members of Congress to support its position against FASB. In December, FASB issues SFAS 123(R) to require the compensation cost of share-based payments, including employee stock options, to be recognized in financial statements.

Comment. As expected, FASB has encountered fierce criticism from the same quarters as it had 10 years earlier with SFAS 123. Congress has become even more engaged on this occasion than before, and in July 2004, by a vote of 312–111, the House actually passed legislation, known as the Stock Option Accounting Reform Act, which would limit the applicability of FASB's standard. Under this bill, the standard would apply only to options issued to the CEO and the next four most highly paid executive officers, for whom the expensing requirement would take effect immediately. It also stipulated that volatility shall be assumed to be zero when using an option-pricing model to estimate the amount of the expense. It would delay any expensing for small companies until three years after the initial public offering had taken place. The bill required the Commerce and Labor Departments to complete, within one year, an economic impact study of the expensing of stock options. One observer has said that a Congressional mandate to change economic reality does not change economic reality. The Senate, which was divided on the contentious subject, did not act on the House-passed bill before Congress adjourned in December. The previous October, FASB said it would postpone the effective date of SFAS 123(R) to June 2005. In doing so, it accepted the SEC's argument that companies were already totally preoccupied at year-end with implementing the internal controls mandated by Sarbanes-Oxley. By next June, it seems very likely that the same coalition that opposed FASB's stock option expensing initiative in 2004 will press again for legislation to prevent SFAS 123(R) from going into effect.

The Future of Standards Setting

When a highly prescriptive standards setter is coupled with a rigorous enforcement process used by a government regulator to secure compliance with accounting standards, especially in a confrontational society such as the United States, companies and even branches of government will lobby the standards setter not to approve standards that interfere with their business plans and strategies. This is what has happened increasingly in the United States since the 1970s, and there is no sign that, on sensitive and controversial issues, it will diminish in intensity or frequency. ❑

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The author used this outline as the basis of a lecture to the International Symposium on Accounting Standards, organized by the Chinese Ministry of Finance and held at the National Accounting Institute in Beijing on July 12, 2004. Portions have been updated to reflect subsequent events.

Photos on pages 18, 20, 24 courtesy of the Financial Accounting Standards Board.

Photo on page 28 courtesy of the SEC Historical Society (www.sechistorical.org).

Timeline photos 1, 2, 3, courtesy of the Accounting Hall of Fame at Ohio State University.

2002

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