Evolution of US Generally Accepted Accounting Principles (GAAP)

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The evolution discussed below should be viewed in the light of a number of important trends in the business and economics scene:

- The expanding public interest in accounting standards, reflecting the enhancement of interest in the equity capital markets and improvements in the extent of coverage of accounting by the financial media
- The increased incidence of business combinations, creating multinationals and conglomerate enterprise
- The great volatility of markets and enterprise performance
- The increased pressure placed on company executives for revenue and earnings performance, leading to the emergence of 'managed earnings'
- The arrival of the post-industrial economy: services v. manufacturing, and the absence of most intangibles from company balance sheets

In the following outline of noteworthy developments in US GAAP from the 1930s to the present, the focus is deliberately on those incidents that represented important changes in practice or in the way in which accounting principles or standards were set. These incidents are typically ones for which interesting 'stories' can be told about the underlying factors that led to the developments. Many of these stories involve efforts by the preparers of financial statements, or by a branch of government, to engage in 'political' lobbying in order to promote their narrow interests, for example, to present a more favorable earnings picture or to promote the effectiveness of government fiscal policy. Yet many US accounting standards have been issued that truly reflect the application of sound concepts, undiluted by 'political' lobbying. Because these principled standards have emerged in a natural progression from the underlying concepts, their stories are not as 'interesting' as those that were driven by 'political' lobbying.

1932-33 Following the Stock Market Crash of 1929, an American Institute of Accountants' special committee, in correspondence with the New York Stock Exchange, recommends five 'broad principles of accounting which have won fairly general acceptance' and introduces the passage '[the financial statements] fairly present, in accordance with accepted principles of accounting consistently maintained' in the auditor's report. These five 'broad principles,' plus a sixth, are approved by the Institute's membership. The purpose is to improve accounting practice.

Comment: The AIA committee said in its recommendation, ‘Within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year.’ This policy was very much that of Price Waterhouse & Co., a firm with British roots, reflecting a ‘disclosure’ approach to accounting policy choice.

1934 Congress completes approval of two major Securities Acts to restore public and investor confidence in the fairness of the securities markets after the Stock Market Crash of 1929; and creates the Securities and Exchange Commission with authority to prescribe ‘the methods to be followed in the preparation of [financial] reports’. The SEC becomes a strict regulator and insists on comparability, full disclosure and transparency. In 1935, the SEC creates the Office of the Chief Accountant. The SEC insists upon historical cost accounting so that the financial statements do not contain ‘misleading disclosures.’

One of the important units created in the SEC is the Division of Corporation Finance, which is charged with reviewing periodic filings by companies to determine whether they satisfy the SEC’s requirements, especially for conformity with proper accounting, full disclosure and comparability.

Comment: The United States is the only country where the government regulator charged with securing compliance with GAAP was established and began its operations before an entity was created to determine what GAAP was to be. In almost all other countries, an entity to determine GAAP was established years or even decades before the government created a regulator to secure compliance with GAAP, if one exists at all.

The SEC’s Division of Corporation Finance (DCF) reviews the financial statements both in periodic filings (on a sampling basis) and in all prospectuses. DCF writes ‘deficiency letters’ to companies, raising questions about certain accounting and disclosure practices. If the company cannot satisfy the DCF of the propriety of these questioned practices, the company is instructed to revise and reissue its financial statements accordingly. If the company were to fail to do so, the SEC would stop the trading of the company’s securities or forbid the public offering of securities. No securities commission anywhere in the world possesses and uses such extensive authority to regulate financial reporting to the degree used by the SEC.

From its founding, the SEC has rejected any deviations from historical cost accounting in the body of the financial statements. This was a reaction to the widespread practice during the 1920s, prior to federal regulation of the securities markets, when listed companies had revalued their assets upward, often based on questionable evidence of their market values. The abuse of this discretion, especially in the public utility field, was believed to have misled investors when judging the values of their shares prior to the Great Crash. The SEC was determined not to allow a repetition of this abuse of judgment. The SEC's unyielding policy on historical cost accounting persisted until 1978, when, for the first time, it proposed a requirement that oil and gas reserves be periodically revalued, with the change taken to earnings.

1936 The Institute publishes *Examinations of Financial Statements*, which introduces the term 'generally accepted accounting principles,' known as GAAP.

1938 SEC issues its first *Accounting Series Release*, which conveys the Commission's views on accounting and auditing. They become known as *Financial Reporting Releases* in 1982.

1938/39 SEC, by a narrow vote, supports a reliance on the private sector to establish GAAP. Under pressure from the SEC's chief accountant, the Institute's Committee on Accounting Procedure begins issuing *Accounting Research Bulletins* to provide the SEC with 'substantial authoritative support' for proper accounting practice. The Committee is composed of practitioners and three accounting academics, all serving on a part-time basis, with a small research staff. Dissents are to be recorded.

<u>Comment:</u> The SEC has never said it has 'delegated' authority to establish accounting principles, or set accounting standards, to the private sector. By law, it cannot 'delegate' that authority. It typically says that it looks to the private sector for leadership in this endeavor. The SEC can overrule the private-sector body, and its accounting staff has regularly maintained a frequent contact with the Committee on Accounting Procedure and its successors, during which it conveys its views.

1938/39 Congress permits companies to use a new inventory method, LIFO, for income tax purposes only if LIFO is also used in all corporate reports. There is immediate pressure to allow LIFO as an accepted practice for financial reporting purposes.

<u>Comment:</u> This is one of the very few instances in which tax policy has influenced GAAP. Congress acted to avoid penalizing corporate taxpayers that purchased nonferrous metals, such as copper, zinc or antimony, whose price fluctuated widely. Under FIFO, they paid excessive income taxes in some years and were not able to obtain refunds in loss years, because of the time lag between purchase and sale. Because LIFO was a novel accounting method, Congress was skeptical of its validity as a measure of income; hence, it imposed the 'LIFO conformity rule,' described above. Companies very much wanted to save taxes by using LIFO and therefore

placed great pressure on the accounting profession to accept it also for financial reporting purposes, which it did.

1939 An Institute committee recommends the wording, ‘present fairly…in conformity with generally accepted accounting principles’ in the standard form of the auditor’s report.

Comment: Unlike the United Kingdom, where ‘true and fair view’ is stipulated in the Companies Acts as the overriding standard that financial statements must attain, ‘present fairly’ in the United States has never been mentioned in federal legislation relating to the opinion given by the external auditor. As a practical matter, ‘in conformity with generally accepted accounting principles’ has implied ‘present fairly.’ The term ‘principles’ in GAAP refers to both principles and practices.

1940 American Accounting Association publishes Professors W.A. Paton and A.C. Littleton’s monograph, *An Introduction to Corporate Accounting Standards*, which is an eloquent defense of historical cost accounting. The monograph provides a persuasive rationale for conventional accounting practice, and copies are widely distributed to all members of the Institute. The Paton and Littleton monograph, as it came to be known, popularizes the ‘matching principle,’ which places primary emphasis on the matching of costs with revenues, with assets and liabilities being dependent on the outcome of this matching.

Comment: The Paton and Littleton monograph reinforced the ‘revenue and expense view’ in the literature and practice of accounting, by which one first determines whether a transaction gives rise to a revenue or expense. Once this decision is made, the balance sheet is left with a residue of debit- and credit-balance accounts, which may or may not fit the definitions of assets or liabilities.

The monograph also embraced historical cost accounting, which was taught to thousands of accounting students in universities where the monograph was, for many years, used as one of the standard textbooks in accounting theory courses. Hence, a generation or more of CPAs ‘grew up’ on historical cost accounting.

1940s During the decade, the Committee on Accounting Procedure frequently allows the use of alternative accounting methods when there is diversity of accepted practice.

Comment: Most of the matters taken up by the Committee during the first half of the 1940s dealt with wartime accounting issues. It had difficulty ‘narrowing the areas of differences in accounting practice’ because the major accounting firms represented on the Committee could not agree among themselves on what constituted proper practice. There were two levels of disagreement. First, the big firms disagreed whether ‘uniformity’ or ‘diversity’ of accounting methods was appropriate. Arthur Andersen & Co. believed fervently that all companies should follow the same accounting methods in order to promote comparability. But such firms as Price Waterhouse & Co. and Haskins & Sells believed that comparability was achieved by allowing companies to adopt the accounting methods that were most suited to their business circumstances. Second, the big firms disagreed whether the Committee possessed the authority to disallow accounting methods that were widely used by listed companies.

1947 Committee issues *ARB* 29, which allows FIFO, LIFO and average; LIFO is accepted primarily because of its acceptability for income tax purposes.

Comment: This was the practical effect of the pressure brought by major companies in the late 1930s and early 1940s to allow LIFO as part of GAAP. In *ARB* 43, issued in 1953, which codified the previous *ARB*s on accounting, LIFO was again allowed as an accepted accounting method, and it still is today.

1947 Committee issues *ARB* 32, which favors the ‘current operating performance’ concept of the income statement, thus displaying ‘unusual’ and ‘extraordinary’ items after net income; the SEC chief accountant, favoring the ‘all-inclusive’ income statement, threatens not to enforce the *ARB*.

Comment: This difference in view reflected the SEC’s skepticism that companies could be trusted to use balanced and fair-minded judgment to distinguish between ‘ordinary’ and ‘extraordinary’ items in the income statement.

1947/48 Contrary to pressure from some major companies, the Committee opposes use of inflation-adjusted depreciation expense except in supplementary disclosures, a view that the SEC supports. Committee reaffirms this view in 1953. In 1947-49, major companies were trying to persuade Congress to allow replacement cost depreciation for income tax purposes, and they hoped that an *ARB* in support of that position would strengthen their argument. The companies were also trying to resist labor unions’ claims for wage increases based on overstated profits during a sharp inflation.

Comment: A deeply ingrained belief in historical cost accounting facilitated the Committee’s decision to reject the recording of inflation-adjusted depreciation in income statements, contrary to the advocacy by a number of major companies. The Committee knew, moreover, that the SEC would not allow companies to use inflation-adjusted depreciation in their income statements even if the Committee had approved of the practice. It was important to the Committee to retain its credibility with the SEC.

In 1950, the Committee did make an attempt to propose an upward revaluation of assets for companies in inflationary times, using as an analogy the downward revaluation of assets (which would be called an 'impairment' today) for companies facing severe financial and economic difficulties. But the SEC made it known that it would oppose any upward valuations, and the Committee therefore abandoned its attempt.

1953 Congress amends the Internal Revenue Code to allow companies to use accelerated historical cost depreciation for income tax purposes. Many companies adopt faster depreciation for taxes but continue to use straight line depreciation in their financial statements, making 'deferred tax accounting' an important issue.

<u>Comment:</u> This was an indication that the Congress and the Treasury Department shared the SEC's view that deviations from historical cost accounting were to be avoided because they were difficult to monitor. Therefore, the legislation allowed accelerated historical cost depreciation, which, it was assumed, would approximate replacement cost depreciation in the early years of an asset's useful life. This was a belated attempt by Congress to meet companies' criticisms that they were being taxed on capital.

This difference between depreciation for accounting and income tax purposes is what led the Committee to discuss whether 'deferred tax accounting' was appropriate, or indeed required, when the difference was due solely to timing.

1950s Leonard Spacek, managing partner of Arthur Andersen & Co., begins to criticize the Committee on Accounting Procedure for allowing alternative accounting methods. This reflects a philosophical split among big accounting firms: uniformity versus flexibility.

<u>Comment:</u> Spacek became a frequent critic of Committee for its reluctance to reduce, or eliminate, the number of optional accounting methods. He was an advocate of 'uniformity.'

1957 In *ARB* 48, the Committee allows the 'pooling of interests' method for business combinations in the presence of certain 'attendant circumstances.'

<u>Comment:</u> This was one of several controversial subjects that the Committee attempted to address during the 1950s. As noted above, the Committee was being criticized for allowing optional accounting methods. The 'pooling of interests' method was advocated by companies engaging in mergers and acquisitions so that they would not have to revalue (usually

upward) the carrying amounts of the merchandise inventories and fixed assets acquired and thus reduce the amount of current and future earnings for the two companies combined. In *ARB* 48, the Committee established a number of criteria for distinguishing between 'poolings' and 'purchases,' but it was not long before these criteria were largely ignored and weakly enforced by the SEC.

1958 In *ARB* 44 (Revised), the Committee favors 'deferred tax accounting' when tax depreciation exceeds depreciation for financial reporting purposes, which is a controversial bulletin.

Comment: This was a courageous bulletin on a controversial subject, yet it dealt with the tax and financial reporting differences relating to depreciation only, and it was not expressed as categorically as some would have liked.

The Committee did not specify whether the 'deferred tax credit' account was a liability or part of shareholders' equity. Shortly afterwards, the SEC's Chief Accountant asked the Committee to clarify the balance-sheet treatment of the credit. Thereupon, the country's largest electric power company brought a lawsuit to enjoin the Committee from issuing the clarification, as it alleged that the classification of the credit as a liability would cause 'irreparable injury' to the company because of its adverse effect on the its debt-equity ratio. The legal case was finally decided by the U.S. Supreme Court on the principle that the Committee had the right to give its opinion on the matter. The Committee then announced that the deferred tax credit should be shown as a liability.

This incident illustrates how far an industry critic might go in attacking the authority of the body that establishes accounting principles.

1959 Provoked by Spacek's criticisms, the Institute (now known as the American Institute of Certified Public Accountants, or AICPA) appoints a special committee to review the role of research in establishing accounting principles. The committee proposes an Accounting Principles Board (APB) to succeed the Committee on Accounting Procedure. The APB comes into existence in 1959 as a senior technical committee of the Institute, and by the following year its 21 members include representatives from all of the Big Eight accounting firms, as well as accounting academics, financial executives, and other accounting practitioners. Dissents are again to be recorded. The APB was charged with 'narrowing the differences in accounting practice,' which meant 'stop allowing so many optional treatments.'

The Institute's Council insists that all of the Big Eight firms be represented on the APB so that they will feel obliged to be sure that their clients follow its norms.

The Institute also creates an Accounting Research Division that is to conduct research to support the APB *Opinions*. Eventually, 15 *Accounting Research Studies* are published under the aegis of the APB.

Comment: This was the second consecutive Institute committee to be charged with establishing accounting principles. Because of the increasing pressure from companies on members of the Committee on Accounting Procedure, it became evident that company financial executives had to be brought into the process for establishing GAAP. Therefore, financial executives were, for the first time, appointed to the Institute committee, now called the APB, which was to establish proper accounting practice. Toward the end of the APB's life, a financial analyst was appointed to the board. All of the members of the APB, as with the Committee on Accounting Procedure, had to be CPAs.

It was a time in which Americans were placing their faith in research. In 1957, the Soviets' Sputnik had beat the Americans into space, and American society responded by taking major steps to enhance the quality of education in the sciences and engineering and also to strengthen the country's research base in all technical fields. This outpouring of support for increasing the investment in research carried over into other fields, including accounting. The new APB was expected to prepare and issue research studies prior to developing its *Opinions*, and its first research assignment was to develop a conceptual framework as the basis for its future work. Research, it was believed, was the most promising means for resolving the intractable philosophical differences between leaders of the accounting profession.

1961/62 The APB's accounting research staff issues *Accounting Research Studies* 1 and 3 on 'basic accounting postulates' and 'broad accounting principles.' These were intended to constitute the conceptual basis for future APB *Opinions* that would, it was hoped, 'narrow the areas of difference.' But the 'principles' *Research Study* advocates current value accounting for inventories and fixed assets, which, the APB asserts in a special *Statement*, is 'too radically different from present [GAAP] for acceptance at this time.' Therefore, *Studies* 1 and 3 fail in their mission to serve as the conceptual basis for future APB *Opinions*.

Comment: Once again, the central question of historical cost accounting versus current value accounting was raised. The SEC Chief Accountant as well as two previous Chief Accountants, all of whom who served on the advisory panel for *Studies* 1 and 3, expressed their unqualified opposition to any deviation from historical cost accounting. Because of the way in which CPAs had been educated since at least the 1930s, few knew anything about current value accounting, and they rejected it if only because it went beyond the expertise they had acquired. In the 1960s, a number of leading accounting academics—Baxter, Edwards and Bell, Solomons, Chambers, and Sterling—wrote articles and treatises advocating one or another version of current value accounting, but their messages were not favorably received by practitioners, by the SEC or by the APB.

1962/63 After Congress enacts an 'investment tax credit' in order to stimulate the purchase of equipment and machinery by companies, the APB issues *Opinion* 2 in a close vote (with four Big Eight firms dissenting) to require that the 'credit' be subtracted from the asset cost, and not be included in current earnings. Under pressure from accounting firms, industry, and the Kennedy Administration, the SEC announces it will allow either accounting method to be used by companies. This decision by the SEC embarrasses the APB. The APB is similarly 'defeated' on accounting for the 'credit' on two subsequent occasions, in 1967 and 1971, because of intensive lobbying by industry.

Comment: This was the first instance in which both government and industry opposed an *ARB* or an APB *Opinion*. The controversy and discord stirred by this episode led the financial press to pay more attention to financial reporting than ever before. In turn, this coverage made even more companies aware of the efforts of the APB to 'narrow the areas of difference,' which companies interpreted as meaning the removal of some of their flexibility in the choice of which accounting methods they might adopt. To many, the disagreement over the accounting treatment of the 'investment tax credit,' which arose on three occasions from 1962 to 1971, was the epitome of 'political' interference in the establishment of accounting principles. The dispute was not over accounting principles but, as far as the government was concerned, concerned the likely impact of the accounting treatment of the 'credit' on the investment and job-creation behavior of industrial companies. To government, it was a matter of providing companies with an incentive, including an accounting incentive, to stimulate the growth of the economy. The companies themselves wanted to report higher accounting earnings in times of an economic malaise.

1964 In *Opinion* 5, the APB establishes criteria for the capitalization of financing leases by lessees, but few lessees actually capitalize the cost and recognize the corresponding liability for long-term financing leases. The leasing industry opposed a stronger set of criteria.

Comment: Leasing as an instrument for long-term financing became a growth industry in the 1950s, and one of the appealing arguments made by the leasing industry was that the leasing of long-lived assets, instead of issuing bonds and buying them, would keep the asset and the corresponding liability off the lessee's balance sheet. Thus was born the infamous term, 'off-balance sheet financing.' Protecting its own self-interest, the leasing industry lobbied the APB not to establish accounting principles that would make leasing unattractive to potential lessees.

1960s The US securities market began to become even more competitive, and the decade is one of numerous multinational and conglomerate mergers. The financial press begins following accounting controversies more closely, and the SEC Chairman begins criticizing the APB for not 'narrowing the areas of difference,' and suggests that, if the APB does not do so, the SEC would do so itself.

<u>Comment:</u> As mentioned above, Congress had authorized the SEC in 1934 to establish proper accounting practice, and in the 1960s the SEC was becoming impatient with the slow progress of the APB in promoting comparability by getting rid of optional accounting methods. The SEC's usual way of inciting the APB into more aggressive behavior was to threaten that it might instead begin establishing accounting principles itself. A view on which all leaders of the accounting profession were united was that this process should remain in the private sector. Of course, the SEC did issue occasional *Accounting Series Releases* on accounting matters, and it could exercise influence over the general direction of the APB's deliberations via oral and written communications between the two bodies. Hence, the SEC was not a passive observer of the process. But it preferred to see the private sector take the initiative for establishing accounting principles, and the AICPA and the accounting firms were willing to underwrite the substantial cost of the process.

1966 APB issues *Opinion* 8, which establishes the principle that pension liabilities during the period of employee service be shown in balance sheets, but the application of the *Opinion* does not result in many companies reporting more pension liabilities.

1966/73/74/2002 The treatment of 'unusual' or 'extraordinary' items has always been fraught with difficulty. In *Opinion* 9, on reporting the results of operations, the APB finally endorses the SEC's preferred 'all-inclusive' income statement, although it says that extraordinary items should be separately reported in the income statement. Previously, companies preferred to place extraordinary news that was bad in the earned surplus statement, and extraordinary news that was good in the income statement. Then, under *Opinion* 9, companies began rationalizing good news as ordinary and bad news as extraordinary. In *Opinion* 30, issued in 1973, the APB, to fix this abuse, establishes a 'Discontinued Operations' section of the income statement and defines 'extraordinary' so narrowly that the classification no longer exists, as a practical matter. Later, in *SFAS* 4, issued in 1974, the FASB designates gains and losses on the premature extinguishment of debt as 'extraordinary.' Finally, in *SFAS* 145, issued in 2002, *SFAS* 4 is rescinded.

Comment: This sequence of developments served to confirm the SEC's belief that companies could not be trusted to use their discretion to make balanced and fair-minded judgments on accounting treatments when they were given the flexibility to do so.

1967 APB issues highly controversial *Opinion* 11 on 'deferred tax accounting' by the thinnest majority, which 'narrows the areas of difference' on this contentious subject. Industry opposes the pronouncement.

Comment: This was one of the APB's successes. Industry opposed this pronouncement vociferously, and companies placed pressure on their audit firms to vote against it. Several days after the final vote was cast, one of the Big Eight accounting firms in the majority signified that it was changing its vote. The *Opinion* was already being printed, and the APB's decision had been announced. To resolve this crisis, the AICPA President called an urgent meeting of the APB members and managing partners of the Big Eight accounting firms, and it was made clear that a vote was final once it was cast at a board meeting. In the end, it was agreed that the original vote to approve the *Opinion* would stand. This illustrates vividly the pressures that would build on the major accounting firms when optional accounting methods were to be disallowed in an *Opinion*.

The process of 'narrowing the areas of difference' was a wrenching experience within the accounting profession, because some firms, including Price Waterhouse and Haskins & Sells, opposed the *Opinion* because they disagreed in principle with 'deferred tax accounting.'

1967 APB issues *Statement* 2, which is not mandatory, on segment reporting. Because the issue is so sensitive among companies, owing to the many conglomerate mergers, the APB feels it cannot compel companies to disclose segment revenues and profits. The Financial Executives Institute undertakes a major research study on the subject so as to persuade the SEC not to make any hasty rules on the sensitive subject.

But in 1969, because of the APB's failure to issue an *Opinion*, the SEC adopts a segment reporting requirement for new issuers, and later extends it to all companies filing annual reports. Finally, in 1976, the FASB issues a standard on the subject.

Comment: As mentioned above, mergers and acquisitions during the 1960s created conglomerate, or diversified, enterprises. The question arose: how well were their respective product lines performing in these new combinations? For competitive reasons, or so they said, the companies did not wish to disclose their revenues or earnings by product line. Investors nonetheless sought out that information. Because of the pressures from industry, the APB could manage to issue only a non-binding *Statement*, not a binding *Opinion*, on the subject. But the pressure on the SEC to take action itself came not from the user community, but from the Congress.

In 1966, the Senate Subcommittee on Antitrust and Monopoly was holding a public hearing on the economic efficacy of conglomerate mergers. One of its witnesses, an economist, contended that it was difficult to evaluate their effectiveness without information about the profitability of their product lines. The Subcommittee's Chairman asked the SEC Chairman if the SEC would be requiring the public disclosure of such information, and the SEC Chairman said that it had no such plans but that it possessed the authority to do so. Not long thereafter, reacting to pressure from the Subcommittee's Chairman (who was a powerful figure in the Congress), the SEC Chairman made it known that he wanted to see the private sector take the lead in recommending disclosures of conglomerate companies' product line information. *Statement* 2, weak though it was, was the APB's response. As indicated, the Financial Executives Institute sponsored a major research study to provide the SEC with guidance. In the end, the SEC acted unilaterally.

1968 The SEC requires, for the first time, a Management's Discussion and Analysis of Operations (MD&A), which is a narrative discussion of the risks and uncertainties facing a company, including their implications for its future liquidity and solvency. In 1974, 1980 and later, the SEC expands the required disclosures to be contained in the MD&A.

Comment: The economic environment and the makeup of business enterprise were becoming increasingly complex and more susceptible to unpredictable change, both domestically and internationally. The SEC believed that investors required a narrative discussion of the risks and uncertainties facing companies, which was information that could not be conveyed in the financial statements and footnotes themselves.

1970 The APB issues *Opinions* 16 and 17 on business combinations and intangibles, following intense lobbying by industry and government either for or against 'pooling of interests' accounting and the mandatory amortization of goodwill over a defined useful life. 'Pooling of interests' is continued in specified circumstances, and the APB requires the amortization of intangibles over a very long life, 40 years, so as to minimize the amount of the amortization expense each year.

Comment: Coming at the end of a decade marked by a record number of mergers and acquisitions, *Opinions* 16 and 17 were preceded by unprecedented lobbying from Corporate America. The Financial Executives Institute blanketed the nation's press with news releases that were critical of the APB, and it lobbied Congress and the SEC as well.

One branch of government advocated the elimination of ‘pooling of interests’ accounting if only to stem the tide of mergers and acquisitions. The Big Eight firms themselves were divided and were under assault by their audit clients. A final vote, by the narrowest majority, in support of an *Opinion* on business combinations and goodwill was thwarted when one of the Big Eight firms changed its mind several weeks after the vote was taken. In order to obtain sufficient majorities on both subjects, the subjects had to be treated in two *Opinions*, which were drafted at the last minute. No one was satisfied with the pressurized way in which these matters were resolved.

1970 The APB issues *Statement* 4, ‘Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises.’ This was originally intended to be an *Opinion*, which has a mandatory character, and was to be the successor to the APB’s failed conceptual framework, *Accounting Research Studies* 1 and 3. By issuing a *Statement*, which is no more than advisory, the APB betrays the deep division of opinion among its members over the formulation of a conceptual framework.

<u>Comment:</u> The firm of Arthur Andersen & Co., in particular, believed strongly that progress could not be made on controversial accounting issues until the APB were to agree on the objectives of financial statements. The firm counted on the APB to issue an *Opinion* on this subject, and when it issued an innocuous *Statement* instead, the Arthur Andersen partner serving on the APB dissented.

1970/71 Three Big Eight accounting firms are so critical of the intense ‘political’ lobbying of the APB leading up to *Opinions* 16 and 17 that they announce they have lost confidence in the APB as a source of sound financial reporting. Criticisms such as these leads the Institute to establish the Wheat Study Group on ‘the establishment of accounting principles’ and the Trueblood Study Group on the ‘objectives of financial statements.’

<u>Comment:</u> Arthur Andersen was one of the three firms. The 1960s had been a decade in which Corporate America and, in some instances, government had lobbied insistently against the APB’s proposed *Opinions*. Company executives were awakening to the strategic importance of flexibility in the choice of accounting methods, especially when engineering, or defending against, company takeovers. Questions were raised whether a part-time board, such as the APB, could stand up against such pressures, because the accounting firms represented on the board had clients with vested interests in the outcome of the board’s deliberations. Many observers concluded that research had not contributed to a resolution of difficult accounting questions, as few of the APB’s *Accounting Research Studies* seemed to have an impact on the board’s thinking.

1971 The APB is successfully pressured by industry not to proceed with possible *Opinion*s on accounting for marketable securities (opposed by the insurance industry), long-term leases (opposed by the leasing industry), and the costs of exploration and drilling of oil and gas (opposed by the petroleum industry). The leasing industry went to members of Congress to prevent the APB from taking action.

Comment: Although the APB always held meetings behind closed doors, it gradually opened its process to symposia and then to public hearings, so that interested parties could express their views other than by writing letters of comment on exposure drafts. All three of these subjects taken up in 1971 were accorded public hearings. Industry opponents continued to be vociferous. The leasing industry organized a national letter-writing campaign to more than 50 members of Congress, in which it was argued that the APB was injuring industry's ability to raise funds for expansion and modernization. After many of the Congressmen who received the letters pointedly inquired of the SEC why the APB would work a hardship on industry, the SEC advised the APB to postpone further action on the subject because of the heightened concern in the Congress.

1971 This was the third occasion when industry prevents the APB from requiring that the 'investment tax credit' be amortized over the useful life of the purchased equipment and machinery instead of taken immediately into earnings. Congress passes legislation authorizing companies to use any method of accounting for the 'credit' which they prefer.

Comment: This was the ultimate denouement for the APB, and it came in December, during the latter stages of the Wheat Study Group's deliberations. This legislation continues to be valid law today, although the 'credit' was reduced to 0% in 1986 and thus is no longer a taxation issue.

1971/72 The Wheat Study Group, appointed in 1971 by the Institute, recommends that an independent, full-time standard-setting body, the Financial Accounting Standards Board (FASB), which would be overseen by a Financial Accounting Foundation, should replace the part-time APB. The FASB would have a large research staff, would follow an elaborate due process, and would have a sizable budget financed by donations to the Foundation and the sale of publications. Dissents would be recorded. The Institute approves this recommendation in its entirety in 1972.

Comment: The FASB began operations on July 1, 1973. It was the first full-time accounting standard setter in the world, and it was hoped that the members' separation from their former employers would assure their independence of mind. To project an air of independence, the FASB's office was deliberately set in suburban Connecticut, to be outside of New York, where many corporate headquarters were located, and outside of Washington, where the SEC was located. The FASB was endowed with a much larger full-time research staff than had been available to the APB, which eventually increased in size to more than 40. The FASB was also the first accounting standard setter to be established apart from the organized accounting profession, and not everyone in the AICPA's leadership was content with giving up one of its most important functions, the setting of accounting standards. Unlike the Committee on Accounting Procedure and the APB, the members of the FASB did not have to be CPAs, and two of the FASB's initial seven members were not CPAs.

The Financial Accounting Foundation raised all of the FASB's funding from the private sector.

1972 John C. (Sandy) Burton, an accounting professor, becomes the first SEC Chief Accountant who had not served on the SEC's accounting staff in the 1930s. He was therefore not imbued with the SEC's philosophical attachment to historical cost accounting. Indeed, he was exposed to the teaching of Professor Philip W. Bell, who was a leading advocate of current cost accounting. Burton was to become an activist Chief Accountant during his term (1972-76). It was not until 1992 that the SEC next appointed a Chief Accountant from outside the Commission's staff.

Comment: Burton had studied at Haverford College, where Bell was a professor. It was not until 1992 that the SEC again hired a Chief Accountant who had not come up through the ranks in the Commission. Since 1992, all of the Chief Accountants have been hired from accounting firms or industry. Burton's background became important in the inflationary decade of the 1970s, when, as will be seen below, he preferred replacement cost accounting to the FASB's preference for general price-level accounting.

Burton was an activist Chief Accountant. During his term, the Commission issued 70 *Accounting Series Releases* (more than a third of which dealt with financial reporting), compared to 126 *Releases* issued during all of the period from 1937 to 1972. He said that he and the FASB had a policy of 'mutual nonsurprise,' by which each would not catch the other by surprise. Yet he surprised the FASB by declaring that, while the FASB should take the lead on issues of measurement, disclosure was primarily the province of the SEC. Many believed, however, that measurement and disclosure were more interrelated than separable. Burton was an articulate spokesman for the SEC's accounting and auditing policies, and he gave numerous speeches.

1973 After the APB hastily issues *Opinion* 31, which requires lessees to disclose certain rental data for non-capitalized leases, the SEC in *Accounting Series Release* 147 responds by requiring lessees to disclose the present value of financial leases and its impact on the lessee's earnings. This SEC initiative provides a transition toward the FASB's *SFAS* 13 three years later, which may have been made somewhat easier to issue because lessees had already been calculating and disclosing the present values of their financial lease commitments in footnotes.

Comment: This Release exemplified Burton's reliance on disclosure to deal with a sensitive accounting matter. To most company executives, disclosure is not seen as a 'threat.' Yet financial analysts thrive on disclosure. One of the enduring findings of the many years of capital market research in accounting is that disclosure is a substantive issue. Yet executives and accountants could be heard to refer to 'mere' disclosure, rather than changing the contents of the balance sheet or income statement, which they believe is the truly substantive act.

1973 The FASB succeeds the APB on July 1, two days after the International Accounting Standards Committee is formed. Together with the establishment in the United Kingdom and Ireland of the Accounting Standards Steering Committee in 1969/70, the formation of both the FASB and the IASC brings the term 'standard setting' into general use.

Comment: The Accounting Standards Steering Committee replaced the English Institute's program for issuing *Recommendations on Accounting Principles*. In the US, the Financial Accounting Standards Board replaced the Accounting Principles Board. The early 1970s, therefore, was when 'setting accounting standards' replaced 'establishing accounting principles,' and the term 'standard setter' came into vogue.

1973 Within the AICPA, the APB is succeeded by the Accounting Standards Executive Committee (AcSEC), composed entirely of accounting practitioners. Its function is to issue *Statements of Position*, later only after approval by the FASB, providing guidance on industry accounting issues. In 2002, the FASB announces that, after a transition, the work of AcSEC is to be discontinued.

Comment: This was the last preserve of the AICPA in the area of accounting standard setting, but the scope of this activity was narrow.

1973 In *Accounting Series Release* 150, the SEC announces that it will look to the FASB for leadership in setting accounting standards.

Comment: This was the SEC's first formal statement of support for a body in the private sector to set accounting standards (or establish accounting principles). Chief Accountant Burton wanted the SEC to give the FASB its full backing.

1973 The Trueblood Study Group, appointed in 1971 by the AICPA, issues a booklet, *Objectives of Financial Statements*, which advocates a 'decision usefulness' approach to the development of accounting standards. It is commended to the attention of the new FASB.

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 Study Group's approach was forward-looking, as 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 Study Group could not agree on whether value changes should be reflected in earnings, but they did provide a framework for thinking about the issue.

1974/75 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 the FASB's belief in 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 round, as under the 'matching principle.'

Comment: The FASB was troubled that the traditional 'revenue and expense view' perpetuated the creation of 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 the FASB, had written an article entitled 'Accounting for What-You-May-Call-Its' in the October 1966 issue of *The Journal of Accountancy* to point out this problem implicit in the 'revenue and expense view.' The board believed 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 the FASB's conceptual framework, was foreshadowed in these two early standards.

1974/76/79 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 some 1,300 large, publicly traded companies to disclose the effects of changing replacement costs in a supplementary disclosure. This rebuff from the SEC embarrasses FASB and forces it to issue *SFAS* 33, in 1979, which requires some 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 his *Release* forced the hand of the FASB to issue a standard on the subject. In the UK, too, 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. General price-level information (known as 'constant dollar' information by the FASB) was easier to audit than current or replacement costs, because the general price indices were published data.

1975 The SEC's Division of Corporation Finance and Office of the Chief Accountant begin to issue *Staff Accounting Bulletins*, which represent the interpretations and practices followed by the Division and the Chief Accountant in administering the disclosure requirements of the federal securities laws. By 2004, more than 100 *SAB*s have been issued.

Comment: This was a step, probably inspired by Chief Accountant Burton, to make known the accounting views held by the SEC's staff without having to obtain the formal endorsement by the Commission.

1975/81 On 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 by hedging and thus risking economic exposure. Industry places pressure on FASB to revise the standard, which is achieved by *SFAS* 52 in 1981, under which certain translation adjustments are excluded from earnings and instead placed in the shareholders' equity section of the balance sheet until the related transactions are consummated.

Comment: Here was an instance in which accounting gains and losses did not necessarily correspond 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, the board decided to remove the translation adjustments from earnings until the eventual consummation of the related transactions. *SFAS* 52 was approved by a 4-3 vote, and the dissenters disagreed, among other things, on the propriety of creating making direct entries in shareholders' equity. The FASB's general dissatisfaction with classifying gains and losses as shareholders' equity is what gave rise to the issue of 'comprehensive income,' which was treated in the board's conceptual framework and was then implemented as a standard in 1997.

1975 By a vote of 5-2, FASB issues *SFAS* 12, on accounting for marketable securities, which requires that unrealized holding gains and losses on marketable equity securities classified as current be taken into earnings, but that such gains and losses on marketable equity securities classified as noncurrent be included in the shareholders' equity section in the balance sheet. This *SFAS*, which was approved by a 5-2 vote, reveals the board's reluctance to reflect upward revaluations of noncurrent assets in earnings.

Comment: This was another area where accumulated gains and losses were parked in shareholders' equity instead of being included in earnings, even though the price of the securities was readily available in the market.

1975-81 Because of the Arab Oil Boycott and 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 some using 'successful efforts costing' and others using 'full costing' in their financial statements. In 1977, FASB issued *SFAS* 19 by a 4-3 vote, which concludes that only 'successful efforts costing' is appropriate. Then the small oil and gas producers, which had all been using 'full costing,' protested vigorously and enlisted support in Congress and from the Departments of Energy and Justice and the Federal Trade Commission. Finally, in *Accounting Series Release* 253, issued in 1978, the SEC says it favors 'reserve recognition accounting,' a version of current value accounting. Then the major oil and gas producers objected, and finally the SEC settled for a lengthy disclosure in the footnotes. Oil and gas companies continue to be able to use either 'successful efforts costing' or 'full costing' in their financial statements.

Comment: The FASB was embarrassed by the SEC's decision to propose a solution other than the one recommended, albeit by a slim majority, by the board. But the SEC Chairman pointed out that this had been a unique case, where the SEC had been expressly charged by the Congress to find a solution. The Chairman said that the SEC continued to have full confidence in the FASB, and, in fact, apart from *Accounting Series Release* 190 on replacement cost accounting (discussed above), this was the only instance in which the SEC 'overruled' the FASB on a substantive accounting issue.

It is a matter of interest that the SEC's decision was formulated by the Commissioners themselves, who were not accountants, 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 the oil-producing states. To non-accountants, historical cost accounting is not a solution that responds to the information needs of investors and creditors. It was the same with the Sandilands Committee, mentioned above. Historical cost accounting is a construct understood by accountants and a puzzle to non-accountants. Non-accountants typically believe the current market values are the relevant information for investors and creditors.

The small- and medium-sized oil and gas exploration companies had rebelled against using ‘successful efforts costing,’ because it would make their earnings trend more volatile and, in the near term, would vastly lower their earnings. They thought that volatile earnings would make it harder to persuade banks to provide them with loans. The Energy Department did not like ‘successful efforts costing,’ and it said so, because the exploration companies’ more volatile earnings would be a disincentive for them to seek oil and gas in untried fields; the riskiness of such drilling would exacerbate their already volatile earnings. And it was the Energy Department’s evolving policy to urge exploration companies to seek oil in new places. The Justice Department, together with the Federal Trade Commission, feared that the required use of ‘successful efforts costing’ by small- and medium-sized exploration companies would lead to such bleak earnings pictures that they might be driven into mergers with the big companies, thus reducing the number of competitors in the industry--which was contrary to their antirust policy. These were all ‘political’ reasons, not accounting reasons. After hearing all of the arguments, the SEC Commissioners said that they favored current value accounting instead of either version of historical cost accounting.

Then, after the SEC proposed to require 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 raising the price of crude every quarter—the American public, which was already critical of the big petroleum companies because of the rising price of fuel and scarcity of supply to the consumer, would rise in wrath against the oil industry. The last thing that the oil and gas ‘majors’ (such as Exxon, Mobil, Gulf and Shell) wanted to report was even higher accounting earnings, as if they were 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 the FASB to issue a standard (which became *SFAS* 69, approved 4-3 in 1982), to 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 the 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, on a vote of 5-1, issues *SFAS* 13, which establishes benchmarks for mandating the capitalization of long-term financing leases on lessees’ books. The *SFAS* is amended numerous times, as the FASB seeks to close loopholes, but the standard 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 FASB standard. It demonstrated that a standard setter should not establish explicit, arbitrary cutoff percentages, else companies seeking to circumvent the intent of the standard will inevitably find ways to do so. It is probably the best example of a 'rule-based' standard that fails to specify a guiding principle.

1976/77 Two Congressional reports recommend that the SEC no longer rely on the FASB for accounting standards but instead issue the standards itself.

Comment: The issue of public-sector versus private-sector standard setting was raised in these reports, but, in the end, no Congressional action was taken on their 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. This pronouncement was approved by a vote of 5-2 after the banking industry argued that a requirement to recognize a loss in such circumstances would lead to a reluctance by banks to renegotiate such loans, thus leading to a higher rate of business failure. This *SFAS*, which served as a basis by which government prolonged and deepened the financial crisis faced by banks and savings and loan institutions in the 1980s, was said by many to be the worst standard ever issued by FASB. *SFAS* 15 was an attempt to avoid recognizing the current value of the renegotiated loan on the books of the financial institution.

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 accounting loss. The 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, Walter B. Wriston, the Chairman of Citicorp and the country's most influential banker, said that, if the banks had known that they might be required to recognize an immediate accounting loss as a result of restructuring the City's debt, he believes that the restructuring would not have occurred. Furthermore, he said, with the prospect of a required recognition of a loss in such cases, he doubted that such restructurings would be possible in the future. His testimony hit like a bombshell. The pressure on the FASB was palpable. 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.

During the 1980s, when many banks and thrift institutions (that is, savings and loan associations) effectively became insolvent because of having made many bad loans, especially at a time of high interest rates, their federal regulators allowed them not to record writedowns and recognize losses after they had restructured the 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 for being economically insolvent. The regulators were seen to use *SFAS* 15 as their justification for adopting this policy.

1977 Responding to criticisms from within the accounting profession, the Financial Accounting Foundation's trustees strengthen FASB's due process procedures and impose a 4-3 majority, instead of a super-majority 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 19 and 34). One change in the board's due process is to open its meetings to public observation ('in the sunshine').

1978-85 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 became more specific, eventually dealing with the sensitive and practical matters of recognition and measurement, the board could only agree to be general and not prescriptive. This reflected the fact that each of the board members has his own individual conceptual framework, which became evident when the 'hard core' issues of recognition and measurement were 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 the 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 *Concepts Statement*, ‘Qualitative Characteristics of Accounting Information,’ published in 1980, was widely imitated in other countries. As mentioned above, the framework incorporated the ‘asset and liability view.’

The series of *Concepts Statements* proved useful to the board when facing novel accounting questions. The board wanted to be guided by principle wherever possible, and the framework contributed toward that end. But it became evident that a considerable amount of reasoning had to bridge the framework with the specific accounting problems to be solved.

The FASB was a pioneer in that it was the first accounting standard setter in the world to complete work on a fully fledged conceptual framework. Since then, the standard setters in Australia, Canada, the UK and New Zealand, as well as the International Accounting Standards Board, have borrowed ideas from the FASB’s framework. In later years, the 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 the longer term, the FASB plans to develop a *Concepts Statement* to clarify the guidance on measurement in *Concepts Statement* 5.

1979 FASB issues *SFAS* 34 by a 4-3 vote, requiring that companies capitalize interest cost for certain self-constructed assets. The *SFAS* was issued to correct an abuse. In 1974, at a time of rising inflation and interest rates, a number of companies began capitalizing, rather than expensing, their interest cost, so as to report higher earnings. The SEC immediately placed a moratorium on this practice until FASB could decide whether it was a proper accounting practice. Previously, interest cost capitalization was practiced only by regulated public utility companies providing electricity and gas services.

<u>Comment:</u> 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 for the consumption of electricity and gas. In that industry, the interest cost incurred to expand plant capacity was to be charged to future generations of users (that is, through capitalization and amortization), when the new capacity goes on line. To expense the cost of interest would, in effect, assess 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 rule that said you could not capitalize the cost of interest. Five years after the SEC, fearing that these companies' financial statements might be misleading to investors and creditors, had placed a moratorium on the practice, the FASB issued its standard on the subject. In *SFAS* 34, it narrowly defined the classes of assets on which interest could be capitalized.

1985/87/90/96 On four occasions, as the flexibility to produce favorable earnings grows in importance to chief executive officers, industry places pressure on the FASB to be more responsive to its objections. Attempts are made to place more industry representatives on FASB and to exercise more control over the FASB's agenda of projects. In 1990, industry succeeds in persuading the Financial Accounting Foundation's trustees to change the majority required to approve standards from 4-3 to 5-2, hoping to slow down the pace of the board. In 1996, SEC Chairman Arthur Levitt, reacting to pressure from the Financial Executives Institute, forces the Foundation 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 decade of the 1980s was again a period of intense merger and acquisition activity, and chief executive officers, as well as chief financial officers, began to pay close attention to the 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 as they increased the proportion of executive compensation in the form of 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 an earnings per share below the forecast. All of these pressures were in turn transmitted to the FASB, and Corporate America sought to have more influence over the actions of the standard setter. Of course, it was known that the SEC would continue to enforce the FASB's standards strictly, imposing heavy penalties for non-compliance.

At the same time, top company executives transmitted these pressures to their accounting department and from there to their external auditor, which is one explanation of the willingness of auditors to accede to marginal and even illicit accounting practices by their clients in the 1990s and early 2000s, known as 'managed earnings.'

While industry enjoyed a few successes in influencing the composition and operating procedures of the FASB, the SEC intervened to protect the independence of the board, especially in 1987 and 1996, when The Business Roundtable and the Financial Executives Institute, respectively, sought to exert more industry control over the operation and governance of the 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 pensions project: three discussion memoranda, six exposure drafts, four public hearings, and six standards. While constituting an improvement on 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 the 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 old, heavy industry, such as automobiles and steel. Once again, the companies pressed the FASB not to heighten the volatility of earnings.

1987 On a 6-1 vote, FASB issues *SFAS* 94, which requires parent companies to consolidate its subsidiaries with 'non-homogeneous' operations, such as the finance subsidiaries of manufacturing parents. The FASB also endorses the notion of 'control' for determining when investee companies should be consolidated, but the board put off implementing the notion. It makes several attempts to implement it in the 1990s but could not agree on an adequate and workable approach for doing so.

Comment: Here, companies were concerned that the consolidation of industrial parent companies with their finance subsidiaries (for example, in 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, side by side.

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 *SFAS* implements a recommendation in *Concepts Statement* 5. FASB allows companies to use either the direct or indirect method of presentation.

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

1987/92 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. After issue of the *SFAS*, 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.

<u>Comment:</u> This was one of the best examples of where the 'asset and liability view' made for a more defensible standard.

1990 FASB unanimously issues *SFAS* 106, accounting for post-retirement health care costs. This standard was strongly opposed by industry; companies did not want to show a liability for the contractual commitments they had given over the years to cover employee health care during their retirement years. General Motors recognized a first-time expense and liability 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 were also hit hard by the newly recognized liability. 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 they had granted to employees over many years. It gave rise to the maxim, 'you manage what you measure.'

<u>Comment:</u> Industry intensely disliked this standard and fought against it; afterwards, companies conceded that it had had a constructive effect on their decision making. It is an excellent example of how a standard can have a considerable impact on company behavior. *SFAS 106* was one of the board's successes.

1993 On a 5-2 vote, FASB issues *SFAS* 115 on accounting for investments in certain equity and debt securities. Although the SEC argued strongly for fair value accounting, with all gains and losses taken to earnings, the banking industry vociferously opposed this solution because of the resulting volatility in their earnings from year to year. A 'political' compromise was thus forced on the board: 'trading securities' v. 'available for sale securities.' Both would be fair-valued in the balance sheet, but the unrealized gains and losses on 'available for sale securities' would be parked in shareholders' equity, and not taken to earnings.

<u>Comment:</u> This 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 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 the Secretary of the Treasury and Chairman Alan Greenspan of the Federal Reserve Board, 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 image 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, that is, those designated as 'available for sale securities,' to be 'buried' in shareholders' equity, while the more modest gains and losses on 'trading securities,' ones that are likely to disposed of very soon, would be shown in the income statement.

1995 In another application of fair value, FASB issues *SFAS* 121, by a 5-2 vote, (1) required companies to recognize the impaired values of assets, but, at the same time, (2) stopped companies from over-accruing provisions ('big bath') that would artificially ensure future reported profits. *SFAS* 121 (which is superseded in 2001 by *SFAS* 144) provides a series of decision rules for such writedowns, including use of the fair value of the impaired assets or, in the absence of a fair value, the present value of their future expected cash flows.

<u>Comment:</u> *SFAS* 121 addressed a problem that had attracted considerable attention in the 1980s, when, it was believed, some companies exaggerated the amounts of their impairment writedowns in order to project a rosy picture for the future. The market ignored massive writedowns in such circumstances and 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 the 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, by the use of option pricing models. But an unprecedented 'political' lobbying campaign by small, high technology companies, which secures the active support of key members of Congress, prevents FASB from requiring the recognition of the stock option expense in companies' income statements. Instead, the amount of the expense, but only for options recently granted, is to be disclosed in a footnote to the financial statements. Had FASB persisted in issuing a standard requiring the expense to be shown in the income statement, Congress may have passed legislation putting FASB, in effect, out of business.

Comment: The run-up to *SFAS* 123 was one of the best-known examples of the extreme use of 'political' pressure, including strong influence exerted by the Congress, on the FASB. By the early 1990s, the awarding of employee stock options to company executives and, in the high tech industry often to all employees, had burgeoned. The last prior 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 were greater than the exercise price. For income tax reasons, the exercise price was always set to equal the market price; hence, no compensation expense at all was recorded. Most observers believed that this compensation was not devoid of cost.

Taking advantage of the literature on option-pricing models, the 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 Corporate America was swift and decisive: they were opposed to any such standard ever taking effect. The Chairman of the FASB confessed that he had never before seen a more livid reaction from chief executive officers to a proposed FASB standard. A standard on the expensing of stock options would directly affect their personal compensation package, as shareholders could be expected to criticize the company when its grants of stock options were to begin depressing the company's reported earnings.

Even stronger objections were registered by the small, high technology industry, based in Silicon Valley and in many other locations around the country. Many of them had been reporting no earnings at all, and they feared that a required expensing of stock options would greatly increase their losses or remove whatever earnings they might ever report. When it became evident that the FASB was determined to proceed with the standard, they appealed to members of the Congress. A sure way to secure the attention of members of Congress, at least then, was to say that a private sector body represented a threat to the viability of high tech entrepreneurship. Members of Congress can react in several ways: write letters to the FASB (which usually are unavailing), hold a public hearing and ask the FASB to defend itself before a hostile audience, or introduce legislation that would order the SEC not to enforce a proposed standard of the FASB.

While some members of the Congress favored the FASB's proposed standards, a much larger number, under pressure from companies that had contributed, or would contribute, to their political campaigns, said they opposed it. Proposed legislation was introduced in both the House and the Senate, either ordering the SEC to enforce the FASB's eventual standard or ordering the SEC not to enforce it. The FASB held public hearings on the East and West Coasts, and the hearing on the West Coast, held at the southern 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 loudly against the FASB.

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

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

Since then, owing to the public pressures arising from the Enron and WorldCom scandals, more than 750 listed companies have 'voluntarily' announced that they will begin to report the expense in their income statement, of which about 125 are included in the Standard & Poor's 500.

1997 By a 5-2 vote, FASB issues *SFAS* 130 on the reporting of 'comprehensive income,' followed up on *Concepts Statement* 3 to require the reporting of 'comprehensive income,' which would include those gains and losses not yet recognized in earnings. It proposes this disclosure either in a separate statement of 'comprehensive income' or in an additional section in the income statement. Industry, however, did not want such gains and losses to be given a high profile, and it 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, and most companies have opted to 'hide' the 'other comprehensive income' in the Statement of Changes in Shareholders' Equity.

Comment: This was an attempt by the FASB to give greater prominence to the gains and losses from foreign exchange translation and on marketable securities that had been included in shareholders' equity. But the Financial Executives Institute pressured the FASB to allow the 'other comprehensive income' to be 'buried' in a statement that few financial statement readers notice.

1997 A practice begins, by Amazon.com and then other high technology companies, of emphasizing 'pro forma income,' 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. The SEC's Chief Accountant and others criticize this practice of emphasizing the positive and de-emphasizing the negative in earnings, thus biasing a company's reporting. The Sarbanes-Oxley Act of 2002 requires that any such 'pro forma income' be explicitly reconciled to GAAP earnings in a prominent place.

Comment: This was a further attempt by industry, especially companies in the high tech field, to 'manage' earnings by focusing readers' attention on the good news. One observer has 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 fought hard against FASB's fair value proposals in the standard. Legislative bills were introduced in both the Senate and the House, and committees held hearings, all to persuade FASB to back down. In the end, FASB succeeds in overcoming the opposition and issues a fairly strong standard on an enormously complex subject.

Comment: As always, this was a highly sensitive subject. It represented yet another example of the use of fair value accounting in the FASB's standards.

2002 On unanimous votes, FASB issues *SFAS* 141 on accounting for business combinations and *SFAS* 142 on accounting for goodwill and other intangibles. The SEC's accounting staff, complaining that 40 percent of its time is spent on the business combinations issue, succeeds in persuading 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 resolved to disallow 'pooling of interests' and to reduce the maximum life for amortizing goodwill and other intangibles to 20 years (from 40 years, set in APB *Opinion* 17 in 1970). Industry objected strongly to this combination of proposals, including especially the required amortization of goodwill, and appealed to Congress for support. Members of the Congress intervened and forced the FASB to consider an annual impairment test for goodwill instead of amortization. Therefore, *SFAS* 141 disallows use of the 'pooling of interests' method, and *SFAS* 142 imposes a mandatory impairment test for goodwill at least once a year, 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 the FASB to converge with the international standard on the treatment of goodwill. While members of the Congress did force the FASB to consider an impairment test for goodwill instead of mandatory amortization, the FASB 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 that set in 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 the FASB.

2002/03 The SEC Chairman and others call for a return to 'principles-based standards' to overcome the current emphasis in the FASB's standards on length and detail. The Sarbanes-Oxley Act of 2002 instructs the SEC to study the merit of principles-based accounting standards. Both FASB and the SEC respond positively, but it has been the SEC's accounting staff that has, over the years, pressed FASB to issue more and more detailed rules, and there is no sign that the staff is changing its approach. The highly litigious environment in the United States is another reason for the detailed accounting standards.

Comment: The FASB is likely to emphasize the principles in their forthcoming standards, but it remains to be seen whether its standards become shorter and less detailed. 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.

2002/03 The Sarbanes-Oxley Act of 2002 requires that FASB be financed henceforth by fees assessed against publicly traded companies, instead of by donations from the interested parties in the private sector. The purpose of this change is to enhance FASB's independence. The Act also charges the SEC with designating a private-sector standard 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 pronouncements of

FASB as being ‘generally accepted’ for purposes of filings with the Commission.

2004 FASB issues an exposure draft to converge with the International Accounting Standards Board’s *IFRS* 2 on share-based payment. As in 1993/94, the small, high technology industry vigorously opposes a required expensing of employee stock options in the income statement, and it has engaged the strong support of more than 300 members of Congress to support its position against the FASB.

Comment: As expected, the FASB has encountered fierce criticism from the same quarters as ten years ago with *SFAS* 123. Congress has become even more engaged on this occasion than in 1993/94, and in July 2004 the House actually passed proposed legislation, the ‘Stock Option Accounting Reform Act.’ It would limit the application of the FASB’s proposed stock option standard to the five highest paid executives in a company, and it stipulates that volatility shall be assumed to be zero when using an option-pricing model to estimate the amount of the expense. It exempts small companies as well as companies that have had Initial Public Offerings for a period of three years. The bill requires 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. It seems unlikely that the Senate will also pass the proposed legislation, but anything can happen.

When a highly prescriptive standard 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 standard setter not to approve standards that interfere with their 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.