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It Really Is Just Trying to Help: The History of FASB and Its Role in Modern Accounting Practices

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I. Leading up to the Creation of the FASB

The Federal Reserve Board (FRB) first attempted to establish guidelines for financial reporting practices in 1917 with its publication of the bulletin, "Uniform Accounting."[1] This bulletin came as a result of the FRB's trepidation in regards to corporate reporting practices.[2] The FRB's concern was not taken seriously, however, because the 1920s and early 1930s were a period of "economic exuberance,"[3] and the occasional critics of financial reporting practices were quickly dismissed as "doomsayers, dangerous to the nation's prosperity."[4] But reality hit when the Dow Jones Industrial Average fell drastically during the market crash that preceded the Great Depression.[5]

Within a few years, an agreement was reached between committees of the New York Stock Exchange and the American Institute of Certified Public Accountants.[6] This agreement focused on five general guidelines for financial reporting.[7] Franklin D.

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1 VAN RIPER, ROBERT, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 4 (1994).

2 *Id.* During that time, many corporations "customarily discounted their commercial paper at member banks," but there was a lack of uniformity and reliability with the reporting. *Id.*

3 *Id.* at 5.

4 *Id.*

5 *See id.* During the market crash, "companies whose shares made up the Dow Jones Industrial Average lost nearly ninety percent of their value in less than three years." *Id.*

6 *Id.* This agreement was reached in 1934. *Id.*

7 *Id.*

> The guidelines were: (1) revenue should not be recognized until a sale is made, and current period expenses should not be deferred in anticipation of sales; (2) expenses should be deducted from income in measuring earnings, not charged to capital surplus; (3) after an acquisition, dividends paid by a subsidiary to its

Roosevelt's New Deal[8] already was in Washington, carried in "on a tidal wave of popular discontent over performance of the economic system."[9] The New Deal's legislation included the "Truth in Securities Law," or the Securities Act of 1933.[10] This act stated that independent public accountants must audit the financial statements of publicly traded companies.[11] This created a foundation upon which the Federal Accounting Standards Board (FASB) would be established forty years later.

The Securities and Exchange Commission (SEC) was created with the hopes of regaining public trust in financial reporting. The Securities Exchange Act of 1934 transferred authority to administer the 1933 Act requirements from the Federal Trade Commission to the newly formed SEC.[12] In 1938, three of the five SEC commissioners voted to rely on the public accounting profession to lead in developing standards in the private sector, while the SEC retained an oversight function and final authority.[13] The Commission decided this private sector body should be the American Institute of Certified Public Accountants (AICPA).[14] The AICPA's Committee on Accounting Procedure (CAP) was charged with identifying acceptable accounting practices.[15] In this charge "were planted the seeds of the notion of 'generally

> new parent out of prior earnings are a return of capital, not income to the parent; (4) dividends on treasury stock should not be treated as income; and (5) receivables from officers and employees should not be included with trade receivables.

Id. at 11 n.8.

8 Roosevelt outlined the New Deal in a fireside chat to the American people on May 7, 1933. Some of the major parts to this legislation included the creation of the civilian conservation corps, easing the burden of debt, undertaking public works projects, pushing through Congress the Farm Relief Bill and the Railroad Bill. FRANKLIN D. ROOSEVELT, OUTLINING THE NEW DEAL PROGRAM (May 7, 1933), http://newdeal.feri.org/texts/380.htm.

9 VAN RIPER, *supra* note 1 at 5.

10 *Id.*

11 *Id.* at 6.

12 *Id.* The Securities Exchange Act of 1934 directed the SEC to determine the "form and content of financial statements issued by those publicly held companies large enough to be required to register with the SEC." *Id.*

13 *Id.* at 7.

14 *Id.*

15 *Id.*

accepted accounting principles' or 'GAAP.'"[16]

The CAP disbanded in 1959 because of "discomfort with the lack of specificity in its work."[17] It was replaced by the Accounting Principles Board (APB), another committee of the AICPA.[18] The APB soon became caught up in problems arising from new kinds of business transactions and new accounting practices.[19] The APB was criticized for concentrating on "firefighting" and ignoring "fundamentals."[20] The APB was criticized also for "its inability as a part-time, volunteer body, to act quickly enough to keep up with developments in the marketplace."[21] As a result of the increasing criticism, then elected President Marshall S. Armstrong convened a conference in Washington in 1971 of a handful of leaders in the public accounting profession to discuss possible solutions.[22] Two study groups[23] were established to research objectives and the establishment of accounting principles.[24] The Wheat Committee report was published in March 1972.[25] It recommended a "new, independent structure for standard setting."[26] The structure included the Financial Accounting Foundation (FAF),[27] the Financial Accounting Standards Advisory Council (FASAC),[28] and the Financial Accounting Standards Board (FASB).[29]

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16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.*

20 *Id.* at 8.

21 *Id.*

22 *Id.*

23 One study group was led by the late Robert M. Trueblood, managing partner of Touche Ross & Co. The other study was led by Frances M. Wheat, an attorney and former commissioner of the SEC. The groups became known by the names of their respective chairman. *Id.*

24 *Id.*

25 *Id.* at 9.

26 *Id.*

27 *See infra* text accompanying notes 30–35.

28 *See infra* text accompanying notes 36–37.

29 *See infra* text accompanying notes 38–51.

II. The Creation of the FASB Organization

A. The Financial Accounting Foundation

The FAF was incorporated in June 1972,[30] with the purpose of operating "exclusively for charitable, educational, scientific, and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code."[31] It is the parent organization in the FASB's structure.[32] There are sixteen trustees[33] who serve no more than two terms of three years each.[34] The trustees' responsibilities include fundraising, appointing members of FASB and FASAC, and reviewing FASB's performance.[35]

B. The Financial Accounting Standards Advisory Council

The FASAC advises the FASB on projects before the Board, including prioritization of projects and suitability of positions that the Board develops regarding its projects.[36] Approximately thirty members are appointed by the FAF trustees for a maximum of four consecutive one-year terms.[37]

C. The Financial Accounting Standards Board

The FASB "was launched amid general optimism and enthusiasm. It was literally unique in almost every respect, most notably in the fact that it was a rule-making body financed and operated entirely in the private sector but whose decisions would be backed by federal law and a powerful federal regulatory agency."[38] The authority of the FASB derives from Congress in the Securities Acts of the early 1930s and comes through the SEC

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30 *Id.*

31 FIN. ACCT. STANDARDS BD., FACTS ABOUT FASB, *available at* http://www.fasb.org/facts/factfasb.shtml (last visited April 5, 2003) [hereinafter FACTS ABOUT FASB].

32 PAUL B. W. MILLER ET AL., THE FASB: THE PEOPLE, THE PROCESS, AND THE POLITICS 18 (Richard D. Irwin, Inc. ed., 1994). [hereinafter MILLER].

33 FACTS ABOUT FASB, *supra* note 31.

34 MILLER, *supra* note 32, at 33.

35 *Id.* at 31.

36 *Id.* at 40–41.

37 *Id.* at 41.

38 VAN RIPER, *supra* note 1, at 13.

and the trustees of the FAF.[39]

In November 1972, Marshall Armstrong was appointed as Chairman of the FASB,[40] and in March 1973, the seven members of the FASB were introduced.[41] Board members are appointed for five-year terms and can be reappointed for one additional term.[42] Members must sever relationships with their prior employers and become full-time employees of the FAF.[43] The FASB's primary responsibility is setting accounting standards,[44] which is accomplished with Statements of Financial Accounting Standards,[45] Interpretations,[46] Statements of Financial Accounting Concepts,[47] and Technical Bulletins.[48]

Following a recommendation by the Foundation Trustees,[49] the FASB opened its meetings to the public in 1978, despite some concern among Board members that discussions would be inhibited and efficiency reduced.[50] In fact, the meetings remained "vigorous and candid" and the responsibility of publicly announcing meeting times and agendas in advance made the operations more efficient.[51]

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39 *Id.* at 189.

40 *Id.* at 9. Armstrong remained Chairman until he retired in 1977. He was succeeded by Don Kirk on January 1, 1978. *Id.* at 63.

41 *Id.* at 10.

42 MILLER, *supra* note 32, at 37.

43 *Id.* at 37.

44 *Id.* at 36.

45 Statements of Financial Accounting Standards (SFAS) create generally accepted accounting principles. *Id.* at 62. The SFASs must be complied with or a company's financial statements are determined not to be in accordance with GAAP. *Id.*

46 Interpretations are used as explanations of an existing SFAS. *Id.* at 63.

47 Statements of Financial Accounting Concepts have significant implications on the development of GAAP in the future. *Id.* at 64.

48 Technical Bulletins are issued by the Research and Technical Activities staff. *Id.*

49 The trustees recommended that the FASB "move into the sunshine" and open its doors to the public. This "implementation of 'sunshine' rules and related changes placed the FASB in the position of having a more open and democratic process than is required of federal agencies under the Administrative Procedure Act of 1947 and the Sunshine in Government Act of 1977." *Id.* at 86.

50 *Id.*

51 *Id.*

III. The FASB's Due Process

The FASB's extensive "due process" was modeled on the Federal Administrative Procedure Act.[52] At the heart of this due process is "open decision-making meetings and exposure of proposed standards for public comment."[53] The FASB's staff presents analyses and recommendations to the Board members in advance of the meeting and makes an oral presentation at the meeting.[54] The Board discusses the issues and asks questions.[55] After a conclusion is reached on an issue, the staff prepare a proposed Exposure Draft, and Board members vote to issue the draft.[56] The staff receives comment letters during the sixty day exposure period, after which positions are analyzed and the comment letters are reviewed.[57] Then, the Board deliberates again, considers comments, and orders the staff to prepare a final document for consideration.[58] Finally, a vote is taken on the final document.[59]

The FASB goes beyond the above-described due process for major projects.[60] After such a project is on the agenda, a task force is appointed to advise the Board on the scope of the project and assist the staff in preparing a Discussion Memorandum.[61] After this discussion document is issued, the Board may hold a public hearing to gain information from constituents.

IV. The FASB's Role in Financial Accounting

Financial accounting "is the practice of providing financial information about an economic entity to people who are not actively engaged in its management."[62] In capitalist markets,

52 FACTS ABOUT FASB, *supra* note 31.

53 *Id.*

54 *Id.*

55 *Id.*

56 *Id.* Four of the seven members must approve a document for it to be issued. *Id.*

57 *Id.*

58 *Id.*

59 *Id.* Four votes are required for the pronouncement to be adopted. *Id.*

60 *Id.*

61 *Id.*

62 MILLER, *supra* note 32, at 9.

decisions are reached through a process involving assessments of future events.[63] Information is at the heart of rational decision-making because it eases uncertainty about predictions of future events and conditions.[64] Financial information is crucial because "it is expressed in terms of money, which serves as a common denominator for allowing different investment and credit opportunities to be compared."[65] Financial statements[66] prepared by corporations are a major source of this important financial information.[67] Financial accounting is the process by which these financial statements are prepared.[68]

"A fundamental premise underlying current financial accounting standards setting is that *uniformity* in the practices used by all reporting companies is generally preferable to diversity."[69] If the information is uniform, it will be easier to make valid comparisons.[70] If the information is uniform, better decisions are possible because managers are less likely to provide biased information to make their companies look better.[71] Thus, managers are protected from other managers who would provide misleading information to gain an advantage in the market.[72] Because uniformity is important, regulation of the flow of information is important as well.[73] This is accomplished by the generally accepted accounting principles (GAAP), a uniform set of agreed-upon rules and guidelines.[74] The FASB has the responsibility of resolving the differences between the different views of what rule should be established to govern various

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63 *Id.* at 11.

64 *Id.*

65 *Id.*

66 A complete set of financial statements includes the statement of financial position (balance sheet), the income statement, the statement of cash flows, and the statement of stockholders' equity. *Id.* at 11 n.2.

67 *Id.*

68 *Id.*

69 *Id.*

70 *Id.*

71 *Id.*

72 *Id.*

73 *Id.*

74 *Id.*

situations.[75]

The FASB's mission is to "establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information."[76] The FASB's goals include increasing the usefulness of financial reporting, updating standards to reflect changes in the business environment, promoting the international convergence of accounting standards, and considering ways to improve areas of deficiency in financial reporting.[77]

The most important project in the FASB's history is the Conceptual Framework,[78] which is a "collection of broad rules, guidelines, accepted truths, and other basic ideas."[79] The Conceptual Framework was part of the FASB's agenda in 1973 and resulted in six Statements of Financial Accounting Concepts being published.[80] The three main reasons for developing this conceptual framework are to describe existing practice, provide guidance to help resolve issues, and define commonly used terms.[81] The Conceptual Framework project resulted in controversy because many constituents preferred the status quo and did not like the prescriptive framework which implied change.[82] Controversy arose also because the developers of the prescriptive framework were forced to resolve many issues at the same time.[83] Consequently, the FASB alternated between the prescriptive and descriptive approaches with the result that the end product was neither descriptive nor prescriptive but simply defined useful terms for the FASB's communications.[84] Thus, many contend that the Conceptual Framework has not met its initial goals established in 1973.[85]

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75 *Id.*

76 FACTS ABOUT FASB, *supra* note 31.

77 *Id.*

78 MILLER, *supra* note 32, at 87.

79 *Id.* at 88.

80 *Id.* at 87.

81 *Id.* at 88.

82 *Id.* at 94.

83 *Id.* at 94.

84 *Id.* at 95.

85 *Id.* at 87.

Currently, the FASB is considering a principles-based approach[86] to standard setting in the United States.[87] Concerns about the quality of financial reporting[88] sparked the FASB's decision to consider a different approach.[89] The Board explained this new approach in its proposal on October 21, 2002:[90]

> In accounting standards developed under a principles-based approach, the principles reflecting the fundamental recognition, measurement, and reporting requirements of the standards would continue to be developed using the conceptual framework. The main differences between accounting standards developed under a principles-based approach and existing accounting standards are (1) the principles would apply more broadly than under existing standards, thereby providing few, if any, exceptions to the principles and (2) there would be less interpretive and implementation guidance (From all sources, not just the FASB) for applying the standards. That, in turn, would increase the need to apply professional judgment consistent with the intent and spirit of the standards.[91]

The public comment period for this proposal ended January 3, 2003.[92] The Board will consider comments made during that period, as well as information gained from roundtable discussions held in December 2002[93] to determine the scope of its actions

86 A principles-based approach is used in developing International Accounting Standards (IAS) and in developing standards in other nations. FIN. ACCT. STANDARDS BD., FASB PROPOSAL: PRINCIPLES-BASED APPROACH TO STANDARD SETTING 4, *available at* http://www.fasb.org/proposals/principles-based_approach.pdf (Oct. 21, 2002) [hereinafter FASB PROPOSAL].

87 FIN. ACCT. STANDARDS BD., PROJECT UPDATES: SIMPLIFICATION AND CODIFICATION, *at* http://www.fasb.org/project/s&c_ project.shtml (last updated Apr. 8, 2003) [hereinafter PROJECT UPDATES].

88 These concerns arose from the growing complexity of accounting standards, which makes it difficult for accounting professionals to stay up-to-date. FASB PROPOSAL, *supra* note 86, at 2. Also, the accounting standards allow "financial and accounting engineering to structure transactions 'around' the rules, thereby circumventing the intent of the standards." *Id.*

89 PROJECT UPDATES, *supra* note 87.

90 *See* FASB Proposal, *supra* note 86.

91 *Id.*

92 *See* PROJECT UPDATES, *supra* note 87.

93 The roundtable discussions were held with various constituents on December 16, 2002. *Id.* The constituents expressed the need for the Board to clarify the term

regarding the adoption of this principles-based approach.[94]

V. International Accounting Standards

As a result of the technological advances and economic growth of the past two decades, a global economy has emerged that includes international capital markets.[95] This new economy poses a challenge for the FASB as questions arise of whether regulated financial reporting will have a role in this new world.[96] "Because of the improved ability to move capital across borders quickly and safely and the desires of investors to invest in other economies, there has arisen the issue of whether regulated financial reporting is as necessary in this arena as it has been within individual domestic capital markets."[97] The stability of domestic systems is jeopardized as companies from other countries obtain capital from local investors without complying with domestic regulations.[98] Thus, the FASB is committed to the development of international accounting standards[99] with the idea that these standards will result in the worldwide use of one set of accounting standards for both domestic and international financial reporting.[100] In its 1998 report, *International Accounting Standard Setting: A Vision for the Future*,[101] the FASB explains its crucial role in the development of international accounting standards:

> The FASB has concluded that whatever the ultimate function of international standards, their use will affect financial reporting

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"principles," to improve its conceptual framework and to establish a transition plan for implementing the new approach. *Id.*

94 *Id.*

95 MILLER, *supra* note 32, at 161.

96 *Id.*

97 *Id.*

98 *Id.*

99 The FASB explains "international standards" as "a set of accounting standards that are internationally recognized as acceptable through, for example, endorsement by the relevant capital market authorities of individual nations and through acceptance by financial statement users." INTERNATIONAL ACCOUNTING STANDARD SETTING: A VISION FOR THE FUTURE, *available at* http://www.fasb.org/IASC/visionpg.shtml (last visited Mar. 17, 2003) [hereinafter INTERNATIONAL ACCOUNTING STANDARD SETTING].

100 *Id.*

101 This report resulted from extensive consultation with FASB members and FAF trustees. Both bodies support the contents of the report. *Id.*

> in the United States, and therefore, the FASB must participate in the process that leads to their development. The FASB believes that its meaningful participation in the development of international standards is necessary to ensure that future international standards are of sufficient quality to be acceptable in the United States.[102]

The FASB's goals regarding the international standards are "to ensure that international accounting standards are of the highest quality and to accelerate convergence of the accounting standards in different nations."[103] High-quality standards are "unbiased accounting standards that require relevant, reliable information that is decision-useful for outside investors, creditors, and others who make similar decisions."[104] Increased quality in international accounting standards results in information that is relevant, reliable, neutral, comparable, and consistent, which in turn results in improved international comparability, lower costs to financial statement preparers and users, and optimal efficiency of capital markets.[105] Convergence means that different standard setters arrive at similar high-quality national or international standards on the same topic.[106] The convergence process incorporates using reasonable efforts to arrive at an agreement.[107] The FASB decided to undertake the development of high-quality standards and convergence as interconnected goals.[108] "Convergence that leads to agreement on a single solution among standard setters in different countries can result in an international standard. Conversely, participating in the development of international standards is one way to facilitate the convergence process and to

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102 *Id.*

103 *Id.*

104 *Id.* Attributes of high-quality standards include: consistency with the underlying conceptual framework; minimization of alternative accounting principles; comprehensibility by preparers, authorities, and users; and the capability to survive thorough interpretation and application for various time periods and companies. *Id.*

105 *Id.*

106 *Id.*

107 *Id.*

108 *Id.* The FASB supports both goals because achieving either increased convergence or high-quality international standards would yield higher quality standards and improved comparability of financial reporting throughout the world. *Id.*

achieve the goal of convergence among nations."[109]

VI. Conclusion

> Financial accounting is considered to be important to the economy as a whole because it provides information that can be used in the capital markets to help investors and creditors in making decisions that affect the allocation of capital resources among the participants in economic activity. If these decisions are made in the light of useful financial information, it is more likely that the economy will be more efficient. And, if the economy is more efficient, it is more likely that society's goals will be fulfilled.[110]

The FASB has made great strides in the financial accounting arena by improving the uniformity and reliability of accounting practices. With its decision to participate in the transition to an international accounting standard, the FASB is in a position to shape the formation of the international standard-setting organization.[111] The FASB likely will continue to play a substantial role in the world of financial accounting in the years to come due to the fact that the FASB organization is responsive to its constituents' needs, and the organization's process of dealing with issues is flexible enough to adjust to changes in those needs.[112]

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109 *Id.*

110 MILLER, *supra* note 32, at 12.

111 INTERNATIONAL ACCOUNTING STANDARD SETTING, *supra* note 99.

112 MILLER, *supra* note 32, at 173.

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