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The Accounting Standards Setting Process in the U.S.: Examination of the SEC–FASB Relationship

Dan Palmon · Marietta Peytcheva · Ari Yezegel

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Abstract In the U.S. there is a close relationship between the Securities and Exchange Commission (SEC), a governmental agency legally responsible for setting accounting standards, and the Financial Accounting Standards Board (FASB), a private sector body to whom the SEC has delegated this responsibility. In this paper we examine the influence of the SEC on the FASB as evidenced by all major statements issued by the FASB. Minor statements, amendments, and strictly technical pronouncements were omitted because of their limited exposure to the political process. Our analysis reveals that the SEC applied substantial pressure on the FASB in the standard setting process and has not adopted a position of benign neglect.

Keywords Accounting standards setting process · Group decision · FASB · U.S. Congress

1 Introduction

This paper analyzes the group decision making process underlying the accounting standards setting in the U.S. by focusing on the interaction between the Securities

D. Palmon
Rutgers University, 180 University Ave., Ackerson Hall Room 304, Newark, NJ 07102, USA
e-mail: dan@palmon.com

M. Peytcheva
Lehigh University, 621 Taylor Street, Rauch Business Center Room 339, Bethlehem, PA 18015, USA
e-mail: marietta.peytcheva@lehigh.edu

A. Yezegel (✉)
Bentley University, 175 Forest Street, Waltham, MA 02452, USA
e-mail: ayezegel@bentley.edu; ariyezegel@gmail.com

and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB). In the U.S., the SEC is legally responsible for accounting standard setting. However, the SEC delegated this task to the FASB which is a private sector body composed of representatives of the accounting profession, industry, financial analysts and academicians.

In response to the accounting standards of the past decade, Congress enacted the Sarbanes-Oxley Act of 2002. The Act imposed limits on the consulting services that auditors could provide for their audit clients, demanded a greater acknowledgment of responsibility by company top executives for company financial information, and established an accounting oversight board. Critics argue that given the recent crisis in accounting, the Sarbanes-Oxley Act should have also re-examined the process by which accounting standards are set. Surprisingly this was not done. This paper examines the group decision making process underlying the U.S. accounting standard setting with the hope of providing findings that will be helpful for future deliberations regarding possible changes in the process.

In order to provide an effective assessment of SEC's influence on the FASB, we examined all major statements issued by the FASB since its inception. We omitted minor statements, amendments and strictly technical pronouncements because of their limited exposure to the political process.

Our analysis reveals that the SEC applied substantial pressure on the FASB (the "noisiest car" in the analogy of Kirk (1981)) in the standard setting process and has not adopted a position of benign neglect. The issues addressed by the FASB, the speed at which the FASB responds, and even its position on certain issues can at times be solely attributed to SEC pressure. In some cases we even witness the SEC provide FASB protection from outside criticism.

2 Theory

The SEC is a federal regulatory agency with standard-setting authority which has chosen to delegate the standard-setting responsibility to a different entity.[1] The FASB has thus been acknowledged to be directly accountable to the SEC. Moreover, representatives of both the FASB and the SEC have recognized and emphasized that the FASB is accountable to the SEC (e.g., Brookings-Institution 2002; Jetuah 2008).

Political science and economics theories suggest that the FASB may be significantly influenced by private parties other than the SEC. Capture theory maintains that regulators would become beholden to the regulated industries that lobby them (e.g., Posner 1974). Similarly, Stigler's theory of economic regulation predicts that private parties will demand regulators to cater to their interests, and that regulators often will end up protecting private, not public, interests (Stigler 1971). Some researchers in accounting have argued along similar lines that the FASB is beholden to industry interest groups (see, e.g., Fogarty et al. 1994 for a review). Others (see, e.g.,

[1] The Sarbanes-Oxley Act of 2002 reaffirmed the SEC's oversight role in the standard-setting process (Sarbanes-Oxley Act, Section 108). Section 108 (c) of the Act states: "Nothing in this Act, including this section […] shall be construed to impair or limit the authority of the Commission to establish accounting principles or standards for purposes of enforcement of the securities laws."

Hussein and Ketz 1980) cast doubt on the allegation regarding the dominance of the Big Eight accounting firms. Hussein and Ketz (1980) examine the allegation that the SEC plays a peripheral role in the setting of accounting standards by focusing on the actual role played by the SEC in the early years of the FASB's existence.

Research in social psychology suggests that accountability to an audience with known views leads decision makers to align their decisions with the views of the evaluative audience to whom they are accountable. Tetlock's social contingency model of judgment and choice predicts that under accountability demands, individuals and groups act as intuitive politicians and adopt strategies of conformity; experimental research has confirmed this model (Tetlock 1983; Tetlock et al. 1989). Based on these findings, we expect that when the SEC's views on a subject matter are known to the FASB, the FASB decisions will be aligned with the SEC views.

Further, the SEC is not *directly* responsible for the standard-setting process. Federal regulatory agencies that are directly responsible for regulation have long been criticized about succumbing to the influence of regulated industries (see Quirk 1981; Baldwin and Cave 1999). One possible consequence from delegating standard-setting responsibility to the FASB could be that the SEC, unlike the FASB, would be less vulnerable to criticism of being beholden to private interests.[2]

The contrast between power and responsibility is an important relevant issue (Epstein and O'Halloran 1999; Schoenbrod 1999). This distinction is especially relevant in the case of regulation. When it comes to standard-setting, the SEC has been given the *power* to regulate. The SEC has, however, delegated the *responsibility* to set accounting standards to the accounting profession. But the SEC has not fully relinquished its actual power to regulate.[3] Some researchers argue that the SEC has veto power over decisions of the FASB (e.g., Newman 1981); others maintain that the SEC has retained much more power and active involvement than that (Ronen 1981). We note that the standard-setting structure placed in effect by the relationship between the SEC and the FASB makes it possible for the SEC to avoid the allegation that it caters to special interests—an allegation that has been directed to other government regulatory agencies, like the FTC or the FDA (Quirk 1981). While the SEC has largely remained free of accusation that it is beholden to special interests itself, the FASB has often been the focus of such allegations (e.g., Watts and Zimmerman 1978). This phenomenon could perhaps be explained using insights from political science research. Governments and other organizations have been found to use decisions of regulatory entities, perceived as independent, to put through unpopular decisions (Vreeland 2003).

[2] SEC officials have previously highlighted the contrast between the FASB and the SEC when it comes to industry influence, e.g.: "Attempting to signal that he is no lapdog to the industry, Mr. Pitt (Chairman of the SEC) promised senators that the SEC would take an active role in overseeing the Financial Accounting Standards Board, which he said was ineffectual and too prone to industry and political pressure" (Schroeder, "Pitt Lashes Out At Criticisms Of Audit Plan", Wall Street Journal March 22, 2002).

[3] From the FASB webpage: "The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest."

Fiorina (1982) develops the "shift the responsibility" model, and proposes that an important motivation of the decision by an entity to delegate authority to another is the desire to shift potential blame. As further explained by Mattli and Büthe (2005), the incentive of a public regulatory entity to delegate authority to a private entity is greater in cases when regulatory activity would be more acceptable to those regulated if the agent (FASB) has some separation from the principal (SEC).

The vast majority of theories that model delegation of policy-making authority have been inspired by rational choice theory (see Bendor et al. (2001) for a review). The game between bureaucratic entities is modeled to include the initial delegation of authority, the choice of policy alternatives, and opportunities for oversight and control.

The fact that bureaucratic agents appear to make policy decisions with little direct input from those who delegated policy-making authority to them does not necessarily mean that agents are indeed responsible for policy choices, or that they have discretion over policy decisions (Calvert et al. 1989). Calvert et al. (1989) propose an analytical model in which an actor with policy-making power delegates policy-making authority to an agent. The delegating actor retains veto power over agent's choices and has complete information about all stages of the process. Notably, the model's equilibrium tells us that although the delegated agents to whom authority is delegated are the active policymakers, the choice of policy is traceable not to their own preferences, but to the preferences of those who delegated authority in the first place. Further, the more important the policy area is to the delegators of policy-making authority, the lower the amount of discretion possessed by the agent to whom authority is delegated. The amount of discretion granted to the agent thus varies inversely with the delegators' perception of the importance of the policy area.

If the relationship between the SEC and the FASB is indeed such that the SEC exercises "control by proxy" over the FASB standard-setting, we would expect to find evidence of collaboration and close interaction between the two entities in the course of setting and amending statement issued by the FASB. An alternative proposition is that the SEC plays a passive role and has no real influence over the FASB and "has reserved a mere oversight role for itself".[4]

Examination of the nature of the SEC's involvement should help determine which of the following descriptions of the SEC's role is more appropriate: our hypothesis of significant SEC input to the standard setting process, or the null hypothesis of no SEC input to the standard-setting process. We hypothesize that the SEC had substantive involvement with the FASB in setting accounting standards, and therefore allegations that the SEC plays only a passive role in the standard setting process have little basis in fact. If the null hypothesis cannot be rejected, perhaps the SEC should be reprimanded and the standard-setting process restructured.Thus, in light of the criticism from two different points of view about the SEC's role in the standard setting process, it is essential that the relationship between the SEC and the FASB be carefully considered. This study aims to illuminate this issue by examining examines the influence of the SEC on the FASB based on all major statements FASB issued.

[4] In 1976, the Metcalf Committee, in its study titled "The Accounting Establishment" reached the conclusion that the Big Eight accounting firms dominate the FASB and its pronouncements while the SEC plays only a passive role.

3 A Brief History of the SEC and the Evolution of Standard Setting Bodies

In 1934, the U.S. Congress established the SEC as an independent federal regulatory agency. The SEC was given the authority by Congress in 1933–1934 to prescribe the form and content of financial statements contained in registration statements that accompany an offer to sell securities to the public and subsequent periodic reports filed with the SEC. Prior to this time, there was neither a public nor private sector program regularly issuing pronouncements on accounting principles.

Early in its history, the SEC attempted to establish a collaborative relationship with the private sector. The SEC, with its authority to prescribe standards established just a few years before, pursued a policy in 1937–1938 that effectively entreated the accounting profession to provide "substantial authoritative support" for sound accounting practices, or GAAP, to the Commission. The private sector's response to this request can be delineated in three stages:

Committee on Accounting Procedure (CAP, 1939–1959)

Composed of 21 part-time members drawn from public accounting and academia, this group was a committee of the AIA/AICPA. Its pronouncements were known as Accounting Research Bulletins.

Accounting Principles Board (APB, 1959–1973)

Composed of 21 part-time members drawn from public accounting, industry, the financial community and academia, this group was a committee of the AICPA. Its pronouncements were known as Opinions (mandatory) and Statements (advisory).

Financial Accounting Standards Board (FASB, since 1973)

Composed of five[5] full-time members, this group is supported and overseen by the trustees of an independent Financial Accounting Foundation (FAF), which in turn is sponsored by eight major professional associations that have an interest in the quality of financial reporting. Its principal pronouncement, which is produced only after extensive "due process" procedures, is known as a Statement of Financial Accounting Standards.

3.1 ASR No. 150

In 1973, with the advent of the independent and well-endowed FASB, the SEC publicly announced, in Accounting Series Release (ASR) No. 150, that, for purposes of its administrative policy enunciated in ASR No. 4 (1938), "principles, standards

[5] In February 2008, the Financial Accounting Foundation Board of Trustees voted to reduce the size of the FASB from seven members to five, effective July 1, 2008 (Financial Accounting Foundation 2008). The FASB agenda-setting process was changed to a "leadership agenda process" whereby the FASB chair has authority to set the FASB agenda, priority of projects, and project plans; the previously existing simple majority voting requirement was retained.

and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgation will be considered to have no such support" (SEC 1973, footnotes omitted). As a result, this succession of private-sector standard setting bodies has not explicitly referenced the SEC in its pronouncements. Nonetheless, prior to the release of ASR No. 150, the SEC had made it clear that it alone possesses the statutory authority for standard setting by means of the Acts that it administers.

The private sector's FAF welcomed ASR No. 150's issuance as "a significant and unprecedented step" toward public-private collaboration on standard setting (Financial Accounting Foundation 1974). However, in no way did the issuance of ASR No. 150, refute the SEC's position—made known in the mid-1960's and before—that failure of the private-sector standard setter to "narrow the areas of difference" between public and private views on standards would result in direct SEC action.

The threat of direct SEC intervention thus continued, even after the issuance of ASR No. 150, to hang over the private sector standard setter's head. Leaders of the accounting profession and the corporate community strongly opposed this ability of the public sector to correct any perceived shortcomings in the standard setting process conducted by the private sector.

3.2 SEC Influence—The Foundation

Since the beginning of the FASB, the SEC's accounting staff kept a close watch over the issues, agendas, priorities, and tentative positions of the standard setter. In keeping with its views about "narrowing the areas of difference" as discussed above, the SEC has not been reluctant to intervene. The two bodies have communicated almost daily on all phases of the development of each standard. Since 1973, the SEC chief accountant attended the quarterly meetings of the FASB's advisory council, and he gave a report on recent SEC developments. In addition, over the years, SEC chief accountants and members of the successive standard-setting bodies made their opinions known in numerous speeches, many of which were published in professional or academic journals. Thus, there has been ample opportunity for each side to know what the other's opinions are as each standard is developed. As part of an effort to facilitate communication between the SEC's accounting staff and the standard setter, there have been regular transfers of personnel between the two bodies. Carman G. Blough, the SEC's chief accountant from 1935 to 1938, became the AIA's first full-time Director of Research in 1944, and remained in that position until 1961. William W. Werntz, the SEC chief accountant from 1938 to 1947 became a member of the Committee of Accounting Procedure in 1950 and served as its chairman from 1956 to 1959. In 1958, when the Institute president appointed a special committee whose report led to the establishment in 1959 of the APB—its purpose would be to succeed the Committee on Accounting Procedure—three of its nine members were the sitting SEC chief accountant, Andrew Barr, and two of the preceding chief accountants, Blough and Werntz.

In 1971, Francis M. Wheat, a former SEC Commissioner, was the chairman of the Blue-Ribbon Committee that proposed a new regime (The Wheat Report) which

became the FASB. Upon FASB's succeeding the APB, Andrew Barr, the SEC chief accountant from 1956 to 1972 became a member of the FASB's advisory council for the period from 1973 to 1976. John C. Burton, the SEC chief accountant from 1972 to 1976, served on the advisory council from 1977 to 1981. A. Clarence Sampson, the SEC chief accountant from 1978 to 1987, was a FASB board member from 1988 to 1993. Moving in the opposite direction, Walter P. Schuetze, who was on the FASB board from 1973 to 1976 became the SEC chief accountant in 1992. This movement back and forth between the SEC's accounting staff and the sphere of the private-sector standard setter has no doubt informed each party of the aims and thoughts of the other.

In addition to the movement of personnel between the two bodies, the nature of the duties of key personnel reinforces this sense of mutual understanding. The SEC chief accountant plays an important role in implementation/compliance matters is his participation at meetings of the FASB's Emerging Issues Task Force (EITF). The EITF seeks to reach a consensus on difficult implementation issues raised by companies, public accounting firms or the SEC. As might be expected, financial instruments occupied a great deal of the EITF's attention. The SEC chief accountant attends as an observer and takes part in the deliberations. The SEC chief accountant generally accepted EITF consensus positions as authoritative support in filings with the Commission (Miller et al. 1998, 159). But he has also occasionally announced his conclusions and forestalled further EITF discussion of an issue.

The SEC also regularly publishes its own accounting positions. From 1937 to 1982, it issued 307 Accounting Series Releases announcing the Commission's opinions and decisions on accounting and auditing matters, about one-third of which resulted from enforcement actions taken against auditors. In 1982, the series was divided into two parts: Financial Reporting Releases, expressing the Commission's positions on accounting and auditing principles and practices; and Accounting and Auditing Enforcement Releases, which communicate enforcement actions taken against auditors. In 1975, the DCF and Office of the Chief Accountant instituted a series of Staff Accounting Bulletins, which convey their interpretations and practices in administering the disclosure requirements of the federal securities laws. However, the Staff Accounting Bulletins do not represent rules or interpretations of the Commission, nor do they bear the Commission's official approval.

In response to a request from a Senate committee, the SEC has presented a report annually since 1978 to Congress on its oversight of the accounting profession, including the standard setting activities of the FASB. The first three reports were issued as separate documents. Subsequent years' reports have been included in the Commission's annual report to Congress. As a practical matter, this oversight role itself as documented in the SEC's annual reports does not seem to have altered the nature of the SEC's relationship with the FASB in the standard setting process.

4 Data and Methodology

To examine the extent of the interaction between the SEC and the FASB on the statements issued by the FASB, the FASB public file for each of the major statements was

examined.[6] These files contain minutes from FASB meetings, discussion memoranda, exposure drafts, letters of comment and records of public hearings; we extracted all evidence of FASB/SEC interaction. Further, we used the FACTIVA database to conduct searches for articles addressing the topics covered in FASB Statements 1 through 158, as well as articles dealing with the SEC or the FASB; we also separately searched the Wall Street Journal Index, New York Times Index, and the Business Periodicals Index. Finally, we reviewed newsletters published by the Big Eight firms and the "News Report" section in the Journal of Accountancy to check current developments on accounting issues.

The question of whether or not the FASB is subject to the SEC's pressure does not lend itself to a quantitative methodology. Accordingly, we identified the following indicators as suggestive of SEC pressure: (1) the degree of SEC involvement in the initial selection of the topics underlying FASB Statements, (2) deviations from the FASB's rules of procedure and the timing of FASB actions in order to accommodate the SEC, (3) similarity between positions taken by the FASB to those sought by the SEC.

A brief outline of the FASB's rules of procedure, presented next, is necessary to identify deviations from these rules.

1. An item seen as a potential problem area as a result of input from the Advisory Council, Accounting Standards Executive Committee of the AICPA or public accounting firms is defined. There is a Committee on Emerging Problems intended as a vehicle for recognizing and initiating action on public issues.
2. The item is formally placed on the Board's technical agenda.
3. A task force is appointed by the Board. Task forces include members from the Advisory Council and are responsible for refining the definition of a problem, recommending the nature and extent of the research to be performed.
4. The task force normally prepares a discussion memorandum (which typically takes 6 months) and upon its issue comments are solicited.
5. A public hearing is held within 30–90 days after the discussion memorandum is issued.
6. An exposure draft of the proposed standard is issued, usually within 10 months of the public hearing.
7. A final standard is issued between 30 and 90 days after the close of the comment period.

An analysis of the political environment associated with the development of each statement follows in the next section. The analysis focuses on (1) the positions of and interactions between the FASB and SEC regarding the specific accounting issue at hand through the seven-step process and (2) the extent to which the FASB deviated from its rules, recognizing that such deviations might stem from political pressure.

[6] A total of 54 statements were examined (see Table 1).

Table 1 Interaction between the FASB and the SEC

Observation	FASB statement number													
	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1. The FASB acts right after a related disclosure requirement is made by the SEC and takes a consistent position		X	X		X	X						X	X	X
2. Initiation of the subject matter by the SEC	X			X				X					X	
3. Threat by the SEC to act if the FASB would not	X			X									X	
4. The FASB acting hastily as a result of SEC pressure	X			X										
5. Change in the FASB rule of procedure to accommodate the SEC														
6. The SEC intervening on behalf of the FASB			X		X			X						
7. The SEC overturns FASB's decision														
8. No observed interaction														

Observation	FASB statement number													
	15	16	19	25	33	34	35	36	52	86	87	88	89	95
1. The FASB acts right after a related disclosure requirement is made by the SEC and takes a consistent position	X	X			X	X				X				X
2. Initiation of the subject matter by the SEC		X	X			X				X			X	X
3. Threat by the SEC to act if the FASB would not														
4. The FASB acting hastily as a result of SEC pressure														

Observation	FASB statement number													
	15	16	19	25	33	34	35	36	52	86	87	88	89	95
5. Change in the FASB rule of procedure to accommodate the SEC		X												
6. The SEC intervening on behalf of the FASB	X													
7. The SEC overturns FASB's decision				X										
8. No observed interaction							X	X	X		X	X		

Observation	FASB statement number													
	96	105	106	107	109	113	114	115	117	119	121	123	123r	128
1. The FASB acts right after a related disclosure requirement is made by the SEC and takes a consistent position						X	X					X		
2. Initiation of the subject matter by the SEC		X	X	X				X		X	X			
3. Threat by the SEC to act if the FASB would not					X									
4. The FASB acting hastily as a result of SEC pressure		X												

Table 1 continued

Observation	FASB statement number													
	96	105	106	107	109	113	114	115	117	119	121	123	123r	128
5. Change in the FASB rule of procedure to accommodate the SEC													X	
6. The SEC intervening on behalf of the FASB													X	
7. The SEC overturns FASB's decision														
8. No observed interaction	X								X					X

Observation	FASB statement number											
	129	130	133	136	140	141	142	143	144	150	154	157
1. The FASB acts right after a related disclosure requirement is made by the SEC and takes a consistent position			X			X						
2. Initiation of the subject matter by the SEC			X			X	X					X
3. Threat by the SEC to act if the FASB would not												
4. The FASB acting hastily as a result of SEC pressure												
5. Change in the FASB rule of procedure to accommodate the SEC						X						X
6. The SEC intervening on behalf of the FASB	X					X						
7. The SEC overturns FASB's decision												
8. No observed interaction		X		X	X			X	X	X	X	

This table provides a descriptive summary of the group decision process underlying the major statements passed by the Financial Accounting Standards Board (FASB). We study all statements, excluding amendments, interpretations, and narrowly focused statements. For each statement we indicate with the letter "X" whether (1) the FASB acts immediately after a related disclosure requirement is made by the SEC and takes a consistent position, (2) initiation of the subject matter was made by the SEC, (3) SEC threatened to act if the FASB would not, (4) the FASB acted hastily as a result of SEC pressure, (5) FASB changed its procedural rules to accommodate the SEC, (6) the SEC intervened on behalf of the FASB, (7) the SEC overturned FASB's decision or (8) there was no interaction between the SEC and the FASB

5 The SEC–FASB Relationship as Evidenced by All Major FASB Statements

Our analysis of FASB statements reveals several modes of SEC involvement in the accounting standards setting process. These modes, which are not mutually exclusive, are described in Table 1 and include:

- FASB acts immediately after a related disclosure requirement is issued by the SEC. The action of the FASB is consistent with the disclosure requirements of the SEC.
- The subject matter is initiated by the SEC.
- The SEC threatens to act if the FASB does not.
- The FASB acts hastily as a result of SEC pressure.
- The FASB changes its rules of procedure in order to accommodate the SEC.
- The SEC intervenes on the behalf of the FASB.

The most common sequence of events surrounding the issuance of an FASB Statement would have the FASB acting immediately after a related disclosure requirement is made by the SEC, taking a position consistent with the SEC. This relationship was found in 18 of the examined statements. The events surrounding Statement No. 14 can be used as an illustration.

In April 1974, the SEC issued ASR No. 154 which required segment reporting. One month later, the FASB issued a discussion memorandum on the very same topic that culminated in Statement No. 14, Financial Reporting for Segments of a Business Enterprise, (December 1976), a statement fully consistent with ASR No. 154. Wagner in a 1976 article appearing in Management Accounting argues that the release of discussion memorandum only 1 month after the ASR was not coincidental; he describes ASR No. 154 as a "subtle hint" from the SEC to the FASB.

The statements where it was noticeable that the SEC initiated the subject matter are numbers 1, 4, 8, 13, 16, 19, 33, 34, 86, 89, 95, 105, 106, 107, 113, 114, 115, 119, 121, 133, 141, 142, and 157. An example of such initiation is Statement No. 13, Accounting for Leases. Evidence that the SEC initiated Statement No. 13 can be found in a speech made by former Chairman of the SEC, G. Bradford Cook: "The accounting profession has probably failed to keep up with the phenomenal growth and complexity of lease arrangements". Furthermore, a speech made by L. Rosen, Associate Director of SEC, San Francisco Office, with regard to this issue, states that the "accounting profession should be concentrating on building new principles while reinforcing old bridges with additional disclosure".

In Statement Nos. 1, 4, and 13, we observe that the SEC not only initiated the FASB's examination of the particular accounting issue but also threatened to act itself if the FASB would not. For example, with regard to Statement No. 4: (Reporting Gains and Losses from Extinguishments of Debt) a February 3, 1973 Wall Street Journal article stated that in addition to open admission by the Board that the topic was placed on its agenda at the urging of the SEC, the SEC threatened to issue the proposed rule itself if the FASB would not.

Examination of Statement No. 1, 4, and 13 also provide evidence that the SEC pressure resulted in hasty FASB action. In these cases, hasty action can be inferred by the omission of discussion memorandums and public hearings. Furthermore, the use of the minimum 30-day exposure period was dispensed with for Statement No. 1: Disclosures of Foreign Currency Translation Information.

The evidence points to the SEC as the motivator for such precipitate behavior. A letter from DeSota, Inc. (dated October 24, 1973), commenting on the exposure draft states that the chief accountant of the SEC threatened that the SEC would act and issue its own pronouncement if the FASB did not. A December 14, 1973 article in the New York Times corroborated the DeSota letter.

Another example of the SEC putting pressure on the FASB relates to Statement No. 109. The SEC expressed impatience with the FASB's timetable relating to this statement, and directed its chief accountant to convey "a sense of urgency" to the FASB so that implementation of the proposal is achieved sooner.

A unique case regarding the SEC–FASB relationship was observed in Statement No. 16. In its first attempt, the FASB was unable to issue Statement No. 16 because only a simple majority, rather than the necessary five votes, supported the issuance of

the statement. However, a short time later, the trustees of the Financial Accounting Foundation approved a proposal of their Structure Committee to change the FASB's voting requirements to simple majority, enabling the FASB to issue Statement No. 16 as sought by the SEC.[7]

Another dimension of the harmony between the SEC and the FASB can be found in the histories of Statement Nos. 2, 3, 5, 8, 123r, 128, and 141. In each instance, the SEC intervened on behalf of the FASB and supported the FASB's position when the latter was criticized by outside groups such as Congress, IRS and industry.

For example, in the issuance of Statement No. 3, a conflict developed between the requirements of the statement and the Internal Revenue Service. The IRS viewed FASB Statement No. 3 as a circumvention of its regulation prohibiting companies using LIFO for tax purposes from using a non-LIFO method for external reporting; the IRS threatened to eliminate the LIFO tax advantage for companies switching to LIFO and reporting according to Statement No. 3 and ASR 159. The SEC in ASR 169 (January 1975) interceded on behalf of the FASB in opposition to the IRS, requiring corporations changing to LIFO to disclose the effect of the change without suffering loss of the LIFO tax benefits.

The SEC lent its support to FASB's position with respect to statement 123r as well. Here, the SEC intervened on FASB's behalf with respect to stock option expensing in the face of opposition by Congress. With strong lobbying by the SEC Chairman, the Stock Option Accounting Reform Act of 2003 (a bill opposing the FASB views) failed in the Senate.

Statement No. 129 also shows the SEC lending support to the FASB. In 1997, several banks protested FASB's handling of the project and demanded a second exposure round; the chairman of the Federal Reserve Board also commented against the FASB's proposal. When the FASB issued a public statement affirming that it saw no need to re-expose, the SEC publicly supported the FASB decision.

While in most cases the FASB took a position which was consistent with the SEC, there exist statements (Nos. 13, 15 and 6) where one may perceive conflict between the two organizations. The most noticeable conflict occurred with the issuance of Statement No. 13 and the question of retroactive application. In the analysis of the events surrounding this statement, we found that the FASB delayed the issuance of the statement and issued a second exposure draft as a compromise to SEC opinion. Thus, the final statement was satisfactory to the SEC.

Another perceived conflict existed with Statement No. 15. The final statement differed from the SEC position which favored present value accounting for banks. In depth analysis of the events leading up to the issuance of the statement indicate complete harmony between the SEC and FASB, but, the discussion memorandum, favoring present value accounting, was vehemently opposed by the strong banking industry. The joint forces of the SEC and the FASB were not strong enough to resist the banks and thus the exposure draft and final statement exclude present value accounting.

A similar case occurred later with the oil and gas industry, in Statement No. 19. The SEC overruled FASB Statement No. 19 in spite of the fact that it initially supported

[7] The voting requirement, changed to a simple majority in 1977, was changed back to a super-majority requirement in 1989, and changed once again to a simple majority requirement in 2002.

this statement; this change in position, however, was due to its inability to resist the industry pressure.

The history of SFAS 19, Financial Accounting and Reporting by Oil and Gas producing companies, provides a classic example of the political interaction in the standard stetting process. The FASB placed accounting and reporting for oil and gas producing companies on its technical agenda in October 1975. Initially, the FASB gave accounting and reporting for oil and gas producing companies' high priority because of the considerable interest generated in the oil and gas industry by the foreign oil embargo and the resulting increases in world oil prices. In December 1975, President Ford signed the Energy Policy and Conservation Act which empowered the SEC to develop appropriate rules for accounting and reporting by oil and gas producing companies. The Act stated that the SEC could, at its discretion, either develop the rules internally or delegate the responsibility to the FASB. With the encouragement of the SEC, the FASB undertook the task of establishing financial accounting and reporting standards for the oil and gas producing concerns.

The FASB considered the following four basic methods of accounting for a company's oil and gas producing activities: full costing, successful efforts costing, discovery value accounting, and current value accounting. In July 1977, after considerable deliberations, the Board issued an exposure draft which required the use of successful efforts method of accounting. The Board decided to recommend the successful effort method of accounting and issued SFAS 19 in December 1977.

As evidenced by Securities Act Release (SAR) No. 5861, issued August 31. 1977, the SEC agreed with the conclusions reached by the Board and indicated the Commission's intent to amend its regulations to incorporate the standards set forth in the exposure draft. The Commission was interested in acting to "beat the December 22, 1977 deadline", the date given by the Energy Policy and Conservation Act's requirements. However, due to industry pressure, the SEC rejected FASB's statement and set out to develop its own standard.

In SFAS 34, "Capitalization of Interest Cost", and SFAS 86, "Accounting for the Costs of Computer Software", the SEC clearly initiated the subject matter. In both instances, the SEC acted by issuing a moratorium, pending FASB's decision.

The SEC also initiated the subject matter of SFAS 33, Financial Reporting and Changing Prices. In 1976, the SEC adopted a replacement cost rule that required certain large public companies to include in their annual reports the cost in current dollars to replace existing "productive capacity". As a result of this disclosure requirement, the FASB began its work on financial reporting and changing prices and issued SFAS 33 which required constant dollar accounting (CDA) and current cost accounting (CCA). Most FASB members were reluctant to include current cost accounting in SFAS 33 but nonetheless included it to satisfy the SEC (Bartlett and Kelly 1980). In light of this fact, it seems ironic that the Board eliminated the CDA while retaining CCA in SFAS 70 and SFAS 82.

Although we found no direct evidence of FASB-SEC interaction in accounting for pension costs, it is interesting to note FASB's cautionary stance. FASB, aware of the need for reform as well as of the pressures from industry for status quo decided to use the "foot in the door" technique. It first established guidelines for accounting for "pension plan" (rather than the Employer). Next, it asked the companies to disclose

the information about the plan in notes. Finally, it required the companies to record a liability if accumulated benefit obligations exceeded fair value of plan assets. Also worth noting is that the FASB deviated slightly from its regular "due process" by its issuance of Preliminary Views which was a intermediate step between Discussion Memorandum and Exposure Draft. The Board issued it to obtain comments on its tentative conclusions.

The third statement which is somewhat inconsistent with the initial position of the SEC, is Statement No. 6. This statement softens certain SEC requirements that proved to be unworkable. Thus, out of the three statements in which a conflict between the FASB and SEC can be detected, only in one (Statement No. 13) did a conflict of substance result in a compromise.

6 Two Examples

As an illustration of the interaction between the SEC and the FASB, we provide brief discussion of the events surrounding the issuance of two statements: SFAS 105 and the more recent SFAS 157.

6.1 SFAS 105: Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk

In 1985, the SEC, in a letter to the FASB, asked the board to commence a project on financial instruments. The SEC was concerned that the level of disclosure in financial statements about financial instruments such as interest rate swaps, options and forward interest rate contracts was inadequate. The FASB, in response to SEC's concerns, on May 15th, 1986 announced a major long-term project to address financial instruments and off balance sheet financing issues. FASB project manager Halsey Bullen noted that:

> The initial objective of the project will be to improve disclosures about financial instruments and off balance sheet financing and hedging arrangements. Standards resulting from this part of the project will probably involve both disclosures of additional data about financial assets and liabilities that now appear on balance sheets and disclosures of information about items that are now off balance sheets. (FASB 1986)

This long-term project was anticipated to have a wide impact on accounting standards including standards APB 21, SFAS 12, 15, 52, 65, 76, 77, 80 and 91.

A year later, on November 30th, 1987, the FASB issued an exposure draft entitled "Disclosure About Financial Instruments" and asked for comments to be submitted by April 30, 1988. The exposure draft received tremendous criticism, with critics contending that the proposed statement was too extensive and that the cost of implementation would be intolerable. However, regulators and legislators, pointed to the insufficient advance warning from financial reports about the impending collapse of companies and financial institutions (S&L crisis), and pressured the FASB to proceed with the

statement. A Wall Street Journal article by Lee Berton (1989) indicated that the FASB chairman Dennis R. Beresford said that he isn't ignoring "the very real criticisms (by business and others) that have been made (of the FASB), particularly those dealing with implementation overload." But he noted that the FASB also must be responsive to legislators and regulators for improved standard-setting to meet "accelerating changes" in business and on Wall Street.

In response to the wide criticism from the industry and support from legislators, the FASB stepped back and undertook a comprehensive review of (1) annual reports of companies that provide additional disclosure of information about financial instruments, (2) SEC and regulatory reporting requirements concerning off-balance-sheet items, (3) approaches taken by other standard setting bodies around the world and (4) comments of task force members and other interested parties and organizations.

The FASB, as a result of its initial review decided to modify its approach and address the disclosure of financial instruments by dividing it into three phases (Disclosure, Recognition and Measurement and distinguishing between liabilities and equity) and focusing on the individual parts. On July 21st, 1989, FASB issued a revised exposure draft entitled "Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk" with a shortened comment period. The second version of the exposure draft focused primarily on off-balance-sheet issues but also included discussion of the concentration of credit risk for all financial instruments. This version of the exposure draft resulted in SFAS 105 entitled "Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk" which was issued in March 1990 and took effect for fiscal years ending after June 15, 1990.

6.2 SFAS 157: Fair Value Measurements

Statement 157 defines fair value and establishes a framework for measuring it according to GAAP; it also expands disclosures about fair value measurements. This statement aimed to unify the dispersed and often conflicting guidance on fair value measurements.

By the early 2000s, the FASB had referenced fair values in some areas of its statements. SFAS 133, Accounting for Derivative Instruments and Hedging Activities (1998), required that entities recognize and measure all derivatives at fair value. SFAS 141, Goodwill and Other Intangible Assets (2001), included guidance about estimating the fair values used in testing both goodwill and other intangible assets for impairment.

In December, 2000, the SEC Deputy Chief Accountant, Day (2000) emphasized the benefits of fair value accounting and highlighted the need for preparers, auditors and users to become better educated about its usage. His speech recommended extending fair value measurement beyond financial instruments, to other assets and liabilities, and expressed the SEC's increasing preference for fair value accounting. The SEC stressed potential problems with unreliable estimates of fair value, and suggested that standard-setters provide detailed "how-to" valuation and guidance for estimating fair values.

In 2002, the Sarbanes-Oxley Act mandated that the SEC conduct a study on the adoption of principles-based accounting standards in the U.S. (Section 108(d)). The SEC initiated a move towards principles-based accounting standards, part of an effort to create "a less complex financial reporting paradigm" approach to accounting standards (Herdman 2002). The FASB responded to these matters by issuing in 2002 a proposal for principles-based approach to standards-setting, which was open for public comment. The comments reflected companies', auditors' and investors' concerns over fair value estimation and measurement, and the insufficient guidance from standards-setters. In June 2003, the FASB reported that, in response to the comments received on its proposal "Principles-Based Approach to U.S. Standard Setting", it has added to its agenda a project to codify and improve guidance for fair value measurement (FASB 2003). The FASB stated that it will prioritize the development of a Fair Value Statement.[8]

In July 2003, the SEC submitted to Congress its Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System. The FASB issued a response to the SEC study in July 2004, welcoming the study and agreeing with its recommendations, and mentioning its fair value measurement project in reaction to the study's recommendations. In 2004, the FASB issued an exposure draft on fair value measurement for public comments. The majority of financial statement preparers, auditors, and users were supportive of the draft; the main concerns were focused on reliability issues.

In 2005, the Acting Chief Accountant of the SEC acknowledged that the major concerns regarding fair value measurement are volatility, reliability, and measurement ability. The speech also emphasized that the disclosures in the FASB's final standard on fair value measurement would help users understand the varying levels of reliability of different fair value measurements (Erhardt 2005). The FASB ultimately issued SFAS 157 in September 2006, and in December 2006, the SEC staff stressed the importance of the statement by stating in a speech that "At this time, it seems appropriate to remind everyone that fair value is a financial reporting concept", defined in SFAS 157; and that "FAS 157's title, 'Fair Value Measurements' makes it pretty clear that it should be read by fair value measurement preparers and reviewers" (Minke-Girard (2006)).

7 Concluding Remarks

The relationship between the SEC and the FASB as described above indicates that the SEC put pressure on the FASB in the standard setting process and did not adopt a position of benign neglect. The issues addressed by the FASB, the speed at which the FASB responds, and even its position on certain issues can at times be solely attributed to SEC pressure. In some cases we even witness the SEC protecting the FASB from external criticism.

[8] Minutes of the FASB meeting on June 4, 2003: http://www.fasb.org/board_meeting_minutes/06-04-03_fv_measurement.pdf.

Our analysis strongly suggests that the SEC is quite active in the standard setting process and not nearly as passive as appears on the surface. We conclude that allegations of weak SEC involvement in the standard-setting process have little basis in fact. Indeed, the SEC involvement is strong and intense and goes beyond the "occasional creative stimulation" as concluded by Burton (1981).

The FASB also plays an important role both in the setting of accounting standards and in the life of the SEC. Kirk (1981) argued that the existence of the FASB is particularly important to the SEC because it removes by one step the inevitable temptation of Congress to let politics influence the setting of financial reporting standards. Since the SEC has the ultimate power of dismantling the FASB and therefore can greatly influence its decisions, the SEC might prefer to have the standards set by the FASB thus maintaining its own (SEC) exposure to political pressures.

The recent Congressional response to the accounting scandals in which investors, employees and others lost their life savings are consistent with these conclusions. As a result of accounting scandals, Congress enacted the Sarbanes-Oxley Act of 2002. Although Congressional Hearings on Sarbanes-Oxley heard much about how poor accounting rules contributed to accounting scandals this new law did not attempt to restructure the accounting standard setting process.

Many blame at least some of the recent financial collapse on the FASB's willingness in SFAS 123 to permit companies that issued stock options a choice between expensing options and footnote disclosure of option costs. This controversial FASB standard provides strong evidence of why we feel the SEC is actively involved in the standard setting process. Though some FASB members strongly felt that requiring expensing was the best alternative, they failed to vote for what they felt was the best standard, in an attempt to avoid a confrontation with the SEC.

The enactment of the Sarbanes-Oxley Act of 2002 gave the SEC additional influence over the FASB by giving the SEC the right to approve FASB's budget. In 2003, former FASB chairman Dennis Beresford stated that the FASB may have less independence from Washington because "The SEC could give it a hard time with its budget". In 2007, the SEC exercised this control over the FASB by refusing to sign off on its budget until the FASB's parent organization (the Financial Accounting Foundation) agreed to give the SEC the power to nominate, interview, and review potential FASB members. This move can also be seen as potentially jeopardizing the independence of the FASB from the political process. Former FASB chairman Edmund Jenkins stated: "I am very concerned that this new protocol provides the basis for Congress—which has the responsibility to oversee the SEC—to get more directly involved with FASB. I think it's a step in the wrong direction."[9]

The present study has focused on a U.S. governmental agency's relationship with the private sector group it empowered with the responsibility to create U.S. GAAP. Future studies along this line could be performed in other countries. One area to consider in this regard is the question of whether the generally positive benefits to the investing public of an SEC–FASB relationship exist in countries that have adopted a similar governmental-private sector structure.

[9] "Is the SEC a Threat to FASB's Independence?" Leone and Johnson, CFO.com, March 30, 2007.

Other aspects of this FASB–SEC relationship might also be considered in light of how FASB standards differ from international ones. For instance, IFRSs on the same accounting issues tend to provide less specificity than FASB statements. Does this greater specificity in FASB rules occur because of the nature of the SEC's relationship with the FASB? As indicated in our paper the SEC has often put pressure on the FASB to not only address certain issues but to respond to them in specific ways. On a macro basis, the IASB is not under this type of pressure. Indeed, in an attempt to satisfy representatives of accounting groups from many different countries the IASB may simply be content to promulgate rules which are sufficiently general so that accountants in a broad range of countries have a workable base from which they can adopt rules that work well in their particular country.

The relationship we explored in this paper between the FASB and SEC may also provide insights into how to accomplish international harmonization of accounting rules. For example, does the experience of FASB when dealing with controversial accounting issues highlight a pathway to international harmonization? The FASB is frequently under pressure from the SEC to deal with controversial accounting issues, and often winds up adopting the standards advocated by the SEC. In contrast the IASC is likely to avoid addressing controversial standards. But, if what was deemed a controversial accounting treatment becomes a FASB standard and works well in the U.S., its perception of controversy may dissipate. This may encourage FASB representatives to the IASC to recommend that the IASC also adopt the treatment, moving one step closer to harmonized accounting rules.

Future extensions of this research may look at additional sources for exploring the FASB–SEC relationship, such as interviews with former and present SEC officers and members of the FASB. This could provide insights unavailable when only using publicly available data. Another direction for extending this research is to examine the interaction between the FASB, SEC, IASB and IASC in the on-going convergence process of accounting standards around the world.

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