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PRIVATE STANDARDS, PUBLIC GOVERNANCE: A NEW LOOK AT THE FINANCIAL ACCOUNTING STANDARDS BOARD

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Abstract: The Financial Accounting Standards Board (the “FASB”) presents a puzzle: How has this private standard setter managed simultaneously (1) to remain independent, (2) to achieve institutional stability and legitimacy, and (3) to operate in a politicized context in the teeth of opposition from its own constituents? This Article looks to governance design to account for this institutional success. The FASB’s founders made a strategic choice to create a regulatory agency that sought independence rather than political responsiveness. The FASB also set out a coherent theory of accounting, the “Conceptual Framework,” to contain and direct its decisions. The Conceptual Framework contributed to the FASB’s institutional success by disavowing a neutral posture, explicitly privileging the interests of the users of financial reports (investors and market intermediaries) over the interests of the reports’ preparers (large audit firms and their managers). Nonetheless, the FASB remains vulnerable to the allegation that its complex, rules-based standards serve the audit firms’ interest in lowering the risk of liability while sacrificing the users’ interest in “fairly” stated financials. This Article endorses the rejoinder position. What some see as capture also can be characterized as “responsiveness,” and the FASB serves a public interest in taking seriously the accounting firms’ need for auditable standards. Although detailed rules can distort the overall story told by a report’s bottom line, they also make it easier to see what preparers are doing, easing verification and making audit failures and scandals less likely. The FASB emerges as a generator of suboptimal but institutionally defensible standards.

INTRODUCTION

Legal theory has long taught that a clear line divides neither public from private law nor the public from the private sector. The legal

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realists showed that private law's most private precincts depend on public coercive power and so are not private at all.¹ Public choice theory made the converse showing—that public law may be viewed as a product of private incentives.² Recent “new governance” theory draws from both of these views to question the tight conceptual connection usually maintained among regulatory authority, hierarchical government, and public accountability.³ It commends a more relaxed approach, both reminding us that private actors, properly incented and deployed, can regulate successfully,⁴ and asking us to think of governance as a cooperative undertaking among public and private actors jointly confronting problems needing solutions.⁵

Standard setting in particular can involve such public-private regulatory cooperation. Government agencies often adopt privately generated product standards and industrial codes to take advantage of inexpensive, private expertise.⁶ But such arrangements can trigger legitimate objections grounded in public values.⁷ Standard setters are accused of being secretive, industry dominated, and unrepresentative of all interested parties.⁸

All of these complaints and many more have been leveled at the Financial Accounting Standards Board (the “FASB”), the private setter of the Generally Accepted Accounting Principles (“GAAP”), which the Securities and Exchange Commission (the “SEC”) imposes on public

¹ See, e.g., Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553, 589 (1933) (contending that contract law, although viewed as “private” in nature, performs essential public functions, such as standardizing conduct); Robert L. Hale, *Coercion and Distribution in a Supposedly Non-Coercive State*, 38 POL. SCI. Q. 470, 470 (1923) (arguing that government must inevitably interfere with economic matters).

² See DENNIS C. MUELLER, PUBLIC CHOICE II 247–73 (1989) (describing government output on the assumption that government actors are selfish utility maximizers).

³ For overviews of this “new governance” approach, see Bradley C. Karkkainen, “New Governance” in *Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lump- ing*, 89 MINN. L. REV. 471, 474–76 (2004) (stressing experimentation and negotiation); Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 344–45, 405 (2004) (stressing reflexivity and soft law). For an intervention from the “new” school concerning securities regulation, see Christie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757, 819–28 (2005) (arguing that new governance “inflected” approaches can improve the inherited deterrence-based securities law regime).

⁴ See IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 54–56 (1992) (describing a tripartite regulatory enforcement strategy that employs private interest groups as monitors).

⁵ Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 548 (2000).

⁶ *Id.* at 640, 642.

⁷ See *id.* at 641–42.

⁸ See *id.*

reporting companies.⁹ The FASB presents itself as an independent, expert, and neutral body whose standards seek only to make transparent the economic reality of reporting companies. Yet, since its founding in 1973, it has been repeatedly criticized for an excessively private coloration, whether due to capture by managers and reporting firms or, alternatively, by the large audit firms.¹⁰ Others allege the opposite, charging the FASB with insensitivity to private interests and excessive independence.¹¹ Some accuse the FASB of promulgating too many standards, others not enough.¹² Some complain that GAAP reports have become too complex due to overly specific, rule-based formulations.¹³ Others complain that the standards provide insufficient guidance.¹⁴ For some the FASB is too slow and for others it changes things too quickly.¹⁵

The complaints are unsurprising.¹⁶ When the FASB sets a new standard, it intervenes in high-stakes territory.¹⁷ Accounting rules implicate the conflicting interests of the firms and managers who prepare financial statements (the “preparers”) and the investors and

⁹ The SEC is required to establish accounting requirements for public companies under § 19 of the Securities Act of 1933. 15 U.S.C. § 77s (2000 & Supp. III 2003). The agency determined that it would rely on a private sector standard setter in 1938. See Administrative Policy on Financial Statements, Accounting Series Release No. 4, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,005, at 72,005 (Apr. 25, 1938). When the FASB emerged in 1973, the SEC duly accorded it authoritative status as the generator of GAAP. See Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 3 SEC Docket 275 (Dec. 20, 1973). Following a directive of the Sarbanes-Oxley Act, the SEC restated its formal recognition of the FASB as an authoritative standard setter in 2003. See Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 8221, Exchange Act Release No. 47,743, 80 SEC Docket 139 (Apr. 25, 2003).

¹⁰ See, e.g., SUBCOMM. ON REPORTS, ACCOUNTING & MGMT., S. COMM. ON GOV'T OPERATIONS, STAFF REPORT: THE ACCOUNTING ESTABLISHMENT 1–2 (1976) [hereinafter THE ACCOUNTING ESTABLISHMENT] (alleging that the FASB dominates the Big Eight public accounting firms and their clients); Donald J. Kirk, *Business and the FASB: The Need for Effective Interaction*, MGMT. ACCT., Sept. 1978, at 17, 17 (noting that public sector regulators and agencies have suggested that the FASB may not be capable of operating in the public interest).

¹¹ See Dennis K. Beresford, *How Should the FASB Be Judged?*, ACCT. HORIZONS, June 1995, at 56, 60.

¹² See *id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 10 (1994) (describing predictions made at the FASB's inauguration).

¹⁷ See Mohamed Elmuttassim Hussein & J. Edward Katz, *Accounting Standards-Setting in the U.S.: An Analysis of Power and Social Exchange*, 10 J. ACCT. & PUB. POL'Y 59, 71 (1991).

other financial market actors who rely on the statements (the “users”).¹⁸ A different accounting rule can lead to different resource allocations,¹⁹ as it impacts, inter alia, stock prices, investment decisions, and executive compensation.²⁰ And despite the FASB’s stated objective to reveal hard economic truth about preparer firms, no hard science of financial reporting exists to import definitive justification to a given standard.²¹ Accounting standards are conventions²² and financial truth is subject to interpretative shading.²³ The standard setter, no matter how well informed, makes a judgment call.²⁴

The charges of capture seem plausible at first. Public accountants fill three of the present FASB’s seven seats and corporate executives occupy two more.²⁵ With a five-to-two advantage, nothing prevents the auditors and the corporate audit clients from acting concertedly when their interests are aligned.²⁶ But the appearance of capture proves deceiving. Neither the coalition hypothesized nor any remotely resembling it has ever emerged on the FASB.²⁷ Observers have intensely studied the FASB, but have failed to uncover signs of outside influence.²⁸ Although capture has been attempted, the FASB has retained its independence, steadily strengthening its institutional position over time.²⁹ As it has done so, however, it has not silenced its critics.³⁰

There emerges a puzzle for those interested in the design of private governance institutions: How can a private standard setter simultaneously maintain its independence and achieve institutional stability while operating in a politicized context, in the teeth of opposition from its own constituents?

¹⁸ See VAN RIPER, *supra* note 16, at 3–4.

¹⁹ See Hussein & Katz, *supra* note 17, at 71.

²⁰ See VAN RIPER, *supra* note 16, at 1–2.

²¹ See Beresford, *supra* note 11, at 61.

²² *Id.* at 57.

²³ VAN RIPER, *supra* note 16, at 1–2.

²⁴ See Beresford, *supra* note 11, at 57.

²⁵ See DAVID R. HERWITZ & MATTHEW J. BARRETT, *ACCOUNTING FOR LAWYERS: MATERIALS* 154 (3d ed. 2002).

²⁶ See *id.* at 154, 156.

²⁷ See Hussein & Katz, *supra* note 17, at 60.

²⁸ See *id.*

²⁹ See Ronald King & Gregory Waymire, *Accounting Standard-Setting Institutions and the Governance of Incomplete Contracts*, 9 J. ACCT. AUDITING & FIN. 579, 586 (1994); George Mundstock, *The Trouble with FASB*, 28 N.C. J. INT’L L. & COM. REG. 813, 817 (2003).

³⁰ See Beresford, *supra* note 11, at 60–61.

This Article looks to “old” governance design concepts to account for this private agency’s institutional success.³¹ The FASB’s founders made a strategic choice between the two leading models of a public regulatory agency: the classical New Deal model of an independent expert and the post-war pluralist model of a politically responsive regulator. They took the New Deal route, structuring the FASB to emphasize independence. Because the New Deal model calls for a normative goal to channel the agency’s exercise of discretion,³² the FASB undertook to set out a coherent theory of accounting, the “Conceptual Framework,” to contain and direct its decisions and thereby to import legitimacy.³³ It did not achieve the stated goal, however: the Conceptual Framework neither determined nor justified the FASB’s subsequent decisions.³⁴ As a result, the FASB never realized the ideal in which agency legitimacy follows ineluctably from the combination of independence and expertise.³⁵ But the Conceptual Framework nonetheless contributed to the FASB’s institutional success by disavowing a neutral posture towards its constituents’ conflicting interests and explicitly privileging the user interest over the preparer interest.³⁶ The FASB has consistently adhered to this repudiation of pluralist responsiveness, whatever its public professions of neutrality. Three results have followed. First, the FASB’s general approach has been defensible as a matter of economic theory. Second, the FASB has faced political opposition from the preparers.³⁷ Although this led to occasional political reversals, it also muted allegations of capture. Third, the preference for users aligned the FASB’s institutional mission with that of the SEC, its public overseer, importing institutional stability if not political invulnerability.³⁸ If not ideally legitimate, the FASB has been legitimate enough.

³¹ For an important discussion of points of friction arising from the FASB’s fulfillment of a public function as a private organization, see generally Lawrence A. Cunningham, *Private Standards in Public Law: Copyright, Lawmaking, and the Case of Accounting*, 104 MICH. L. REV. 291 (2005).

³² See JAMES M. LANDIS, *THE ADMINISTRATIVE PROCESS* 39, 50–51 (1938).

³³ See Katherine Schipper, *Principles-Based Accounting Standards*, ACCT. HORIZONS, Mar. 2003, at 61, 62–63.

³⁴ See Mundstock, *supra* note 29, at 830–39.

³⁵ See Beresford, *supra* note 11, at 60–61.

³⁶ See OBJECTIVES OF FIN. REPORTING BY BUS. ENTER., Statement of Fin. Accounting Concepts No. 1, § 34 (Fin. Accounting Standards Bd. 1978) [hereinafter FASB, SFAC No. 1], available at <http://www.fasb.org/pdf/con1.pdf>.

³⁷ See VAN RIPER, *supra* note 16, at 75–76, 118–22.

³⁸ See *id.* at 141.

The FASB remains vulnerable to a secondary capture allegation. Critics charge that its complex, rules-based standards serve the audit firms' interest in lowering the risk of liability while sacrificing the users' interest in "fairly" stated financials.³⁹ They contend that "principles-based" standards would be better.⁴⁰ The critics have a point. But this Article endorses the rejoinder position. What some see as capture also can be characterized as "responsiveness." The FASB serves a public interest in taking seriously the accounting firms' need for audit-able standards. Even as detailed rules can distort the overall story told by a report's bottom line, they make it easier to see what preparers are doing, easing verification and making audit failures and scandals less likely. In this post-Enron era, scandal prevention arguably takes a legitimate place with transparency as a public-regarding goal for the GAAP setter.

The FASB emerges as a generator of suboptimal but institutionally defensible standards. Part I describes the FASB's founding and subsequent history as an effort to stay legitimate while simultaneously maintaining independence and avoiding pluralist subordination to constituent interests.⁴¹ As means to these ends, the FASB's organizers have drawn liberally on "public" devices in the tool box of administrative process. This ongoing process, which recently climaxed with the Sarbanes-Oxley Act of 2002 ("SOX"),⁴² has over time embedded the FASB in the regulatory framework of American business. Part II shows the connection between the FASB's adherence to the New Deal model of the independent, expert agency and the Conceptual Framework's declaration of a goal, "decision usefulness," favoring the user over the preparer interest.⁴³ Part III turns to the standards themselves, taking up the rules-versus-principles debate and the subsidiary capture question.⁴⁴

I. FORMATION, PROCESS, AND STRUCTURE

This Part explains the FASB's founding and organization as an exercise in agency design under the classical expertise model.⁴⁵ The

³⁹ See *The Lessons from Enron*, *ECONOMIST*, Feb. 9, 2002, at 9, 9–10.

⁴⁰ *Id.*

⁴¹ See *infra* notes 45–212 and accompanying text.

⁴² Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

⁴³ See *infra* notes 213–318 and accompanying text.

⁴⁴ See *infra* notes 319–442 and accompanying text.

⁴⁵ See *infra* notes 49–212 and accompanying text.

model teaches that it does not suffice to delegate standard-setting authority to competent experts and then leave oversight to the legislative principal and the public. The resulting zone of discretion under such circumstances will be unsatisfactorily wide, particularly if any question arises respecting the standard setter's independence. Such was the problem with accounting standard setters that preceded the FASB. The FASB's founders accordingly attempted to separate the standard setter from the preparers, the users, and the accounting profession. According to the classical theory, however, such a separation still will not suffice to import legitimacy. The independent agent's expertise will contain its discretion only if the agency pursues an ascertainable goal. The original FASB sought to put itself inside the model by articulating a Conceptual Framework for accounting.

Many found the design intrinsically infirm, however. From a public choice point of view, independence and expertise prevent neither empire building by the agency nor capture by the regulated interest. From a public interest point of view, the classical model leads to insensitivity to public demands and so cannot legitimately be employed with private actors. The FASB, sticking to the classical playbook, survived attacks from both points of view. But it also reformed itself over time, taking on more and more of the procedural earmarks of a public institution. Section A describes the FASB's founding and design.⁴⁶ Section B describes the criticisms leveled against it.⁴⁷ Section C describes its subsequent organizational evolution.⁴⁸

A. Foundation and Design

1. Antecedents and Founding

Institutionalized standard setting came to accounting in the wake of the enactment of the federal securities laws,⁴⁹ which directed the SEC to prescribe the form and content of financial statements.⁵⁰ The SEC went back and forth on what to do about the matter for several

⁴⁶ See *infra* notes 49–130 and accompanying text.

⁴⁷ See *infra* notes 131–164 and accompanying text.

⁴⁸ See *infra* notes 165–208 and accompanying text.

⁴⁹ Previous initiatives had been small scale and applied only to selected industries, and so left conflicts unresolved. Hussein & Katz, *supra* note 17, at 72; see also FED. RESERVE BD., UNIFORM ACCOUNTING 5 (1917).

⁵⁰ See generally Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74. For a review of the legislative history, see Sean M. O'Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741, 798–820 (2004).

years,⁵¹ finally determining in 1938 to delegate the job of providing "substantial authoritative support" for accounting treatments to the accountants' professional organization, the American Institute of Accountants (the "AIA") (later the American Institute of Certified Public Accountants (the "AICPA")).⁵² The AIA responded in haste, creating the Committee on Accounting Procedure (the "CAP").⁵³ This committee was made up of twenty-one part-time, geographically dispersed members, most of whom were certified public accountants ("CPAs").⁵⁴ The committee also included a few academics,⁵⁵ as well as a two-member staff.⁵⁶ The AIA assigned the CAP a limited mission: to recommend acceptable standards by drawing from the wider menu of prevailing practices, rather than to set new standards.⁵⁷ Preparers were not compelled to adopt them and the CAP was flexible about available alternatives.⁵⁸ The CAP's constituents, however, disliked this ad hoc approach, demanding more uniformity and specificity.⁵⁹

In 1959 the AICPA dissolved the CAP and substituted a new committee, the Accounting Principles Board (the "APB"), which survived until 1973.⁶⁰ The APB's twenty-one part-time members included preparers and users in addition to CPAs and academics.⁶¹ It also had a research staff.⁶² But the APB satisfied neither the preparers nor the audit profession.⁶³ Those were Wall Street's "go-go" years, and the flow of new accounting issues outstripped the APB's capacity.⁶⁴ Revenue recognition problems, off-balance-sheet leases, and the new investment tax credit all triggered controversy.⁶⁵ Worse, the APB was

⁵¹ See ROBERT CHATOV, *CORPORATE FINANCIAL REPORTING: PUBLIC OR PRIVATE CONTROL?* 111-32 (1975).

⁵² See Stephen A. Zeff, *A Perspective on the U.S. Public/Private-Sector Approach to the Regulation of Financial Reporting*, ACCT. HORIZONS, Mar. 1995, at 52, 55.

⁵³ See VAN RIPER, *supra* note 16, at 7. For a history of the CAP, see CHATOV, *supra* note 51, at 133-52.

⁵⁴ Zeff, *supra* note 52, at 55-56. Note that Chatov states that there were eighteen members on the committee. CHATOV, *supra* note 51, at 196.

⁵⁵ Zeff, *supra* note 52, at 55-56.

⁵⁶ CHATOV, *supra* note 51, at 134.

⁵⁷ VAN RIPER, *supra* note 16, at 7.

⁵⁸ CHATOV, *supra* note 51, at 134; King & Waymire, *supra* note 29, at 584.

⁵⁹ VAN RIPER, *supra* note 16, at 7; King & Waymire, *supra* note 29, at 582-83.

⁶⁰ For a history, see CHATOV, *supra* note 51, at 195-233.

⁶¹ Zeff, *supra* note 52, at 56.

⁶² CHATOV, *supra* note 51, at 196.

⁶³ See *id.* at 197-99; VAN RIPER, *supra* note 16, at 8.

⁶⁴ See VAN RIPER, *supra* note 16, at 7.

⁶⁵ *Id.* at 57-59.

seen as dominated by large accounting firms.⁶⁶ To some, this implied preparer capture, as the CPAs yielded to pressures from their clients.⁶⁷ But the preparers did not get all the treatments they wanted; in fact, they complained of underrepresentation.⁶⁸ The APB also was charged with developing a fundamental accounting theory—a conceptual framework to guide its standard setting.⁶⁹ But it made little progress there as well.⁷⁰ Indeed, the project came to an end when its staff produced its first Accounting Research Study recommending radical departures from cost accounting.⁷¹ The APB itself rejected the initiative.⁷² In the end, the APB's failure to promulgate a timely standard to govern mergers exhausted the patience of the large accounting firms.⁷³

In 1971, the AICPA convened a conference of auditors, preparers, and users that appointed two study groups to consider what to do next.⁷⁴ A follow-up conference considered and endorsed the study groups' recommendation that the standard setter remain private, so as best to draw on private sector expertise and avoid susceptibility to political pressure.⁷⁵ But, on this third try, the conference participants decided that the standard setter's structure should not only guarantee independence, but also assure better constituent representation.⁷⁶ Thus did the FASB emerge in 1973 out of a series of private negotiations among representatives of its various constituents.⁷⁷ The SEC quickly accorded it authoritative status.⁷⁸

2. Design

Independence meant formal separation from constituent groups, so the primary structural change occurred at the top.⁷⁹ The standard setter was pulled from the AICPA and reorganized under the Financial

⁶⁶ Hussein & Katz, *supra* note 17, at 73.

⁶⁷ *See id.*

⁶⁸ VAN RIPER, *supra* note 16, at 8.

⁶⁹ *See id.* at 7.

⁷⁰ *See id.*

⁷¹ *See* King & Waymire, *supra* note 29, at 583.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ VAN RIPER, *supra* note 16, at 9.

⁷⁶ *Id.*

⁷⁷ *See* Hussein & Katz, *supra* note 17, at 76.

⁷⁸ *See* Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, *supra* note 9.

⁷⁹ *See* VAN RIPER, *supra* note 16, at 9.

Accounting Foundation (the "FAF"), an independent not-for-profit entity.⁸⁰ The FAF's nine trustees were to come from five sponsoring organizations, representing CPAs, preparers, users, and academics.⁸¹ But the accounting profession did not cede a position of primary influence—the AICPA had a majority of five seats.⁸² The FAF's (and thus the FASB's) funding came from contributions from the participating professional organizations, the large accounting firms, and preparers.⁸³

A board comprised of seven full-time members appointed by the FAF trustees replaced the part-time, dispersed, and dysfunctional APB board of twenty-one.⁸⁴ This new structure enabled the board to act more quickly. The seven members were to sever their connections with their employers, divest their investments, and go on salary for five-year terms (with possible reappointment).⁸⁵ Four of the seven members were required to be CPAs; the others were to be "well versed in problems of financial reporting."⁸⁶ Voting was to proceed on a five-to-two supermajority basis.⁸⁷ Rules of Procedure, ever since referred to as the FASB's "due process," were to be adopted and followed.⁸⁸ Independence also meant distance from constituents and politicians, so Connecticut was chosen as the venue over New York or Washington.⁸⁹ Finally, for the founders, independence also implied secrecy.⁹⁰ The original FASB met in private prior to the publication of a new standard's Exposure Draft.⁹¹ Member dissents were not published.⁹²

Constituent responsiveness was addressed, if not assured, through the establishment of an advisory body, the Financial Accounting Standards Advisory Council (the "FASAC"), appointed by the FAF and

⁸⁰ *See id.*

⁸¹ *Id.* at 14. The sponsoring organizations were the AICPA, the American Accounting Association (educators), the Financial Analysts Federation (now the Association for Investment Management and Research), the Financial Executives Institute, and the National Association of Accountants. *Id.* The Securities Industry Association joined a few years later. *Id.*

⁸² *Id.* Three of the remaining seats were to come from the preparers and users; one was to be an academic. CHATOV, *supra* note 51, at 5.

⁸³ *See* Nanette Hagood & Ray G. Stephens, *A Guide to Standard Setting Bodies*, OHIO CPA J., Aug. 1995, at 44, 44.

⁸⁴ *See* CHATOV, *supra* note 51, at 233; Zeff, *supra* note 52, at 56.

⁸⁵ VAN RIPER, *supra* note 16, at 17.

⁸⁶ CHATOV, *supra* note 51, at 5.

⁸⁷ VAN RIPER, *supra* note 16, at 87.

⁸⁸ *Id.* at 18.

⁸⁹ *Id.* at 13.

⁹⁰ *See id.* at 18.

⁹¹ *Id.*

⁹² King & Waymire, *supra* note 29, at 586.

overseen by the chair of the FASB.⁹³ The FASAC would contain twenty-seven members representative of the constituent groups and possessing skills valuable to the FASB;⁹⁴ the SEC's Chief Accountant also was to be a member.⁹⁵ It was to consult with the FASB on policy issues and technical matters, so as to help it prioritize, set agenda items, and keep things moving.⁹⁶ Although it has always been relegated to an advisory role, the FASAC has fulfilled these duties and never hesitated to criticize the Board.⁹⁷

The FASB's founders, then, wanted the new standard setter to be independent yet responsive to constituent interests.⁹⁸ In addition, they wanted the FASB to remain insulated from political pressure.⁹⁹ But they left one problem unresolved. As they saw it, the new agency had no substantive mandate on which to draw in drafting standards.¹⁰⁰ The constituents needed to come to a basic agreement, if not on the terms of particular standards, then at a more general level on the substantive mission of the enterprise.¹⁰¹ The founders left this constitutional task to the agency itself.¹⁰² The early FASB responded with the Conceptual Framework, a series of statements intended to provide a unified theoretical basis from which to articulate standards, stressing financial statement reliability, comparability, and relevance to users.¹⁰³

⁹³ See VAN RIPER, *supra* note 16, at 17.

⁹⁴ *Id.* In 1975, the FASAC was comprised of six members from large audit firms, five from corporations, eight from the financial sector, three academics, two lawyers, two from government, and a former SEC chief accountant. CHATOV, *supra* note 51, at 5.

⁹⁵ CHATOV, *supra* note 51, at 5.

⁹⁶ *Id.* at 234.

⁹⁷ VAN RIPER, *supra* note 16, at 17; Hagood & Stephens, *supra* note 83, at 44; King & Waymire, *supra* note 29, at 597.

⁹⁸ See CHATOV, *supra* note 51, at 232–39; VAN RIPER, *supra* note 16, at 9, 17.

⁹⁹ VAN RIPER, *supra* note 16, at 9.

¹⁰⁰ See Kirk, *supra* note 10, at 18.

¹⁰¹ See *id.*

¹⁰² See *id.*

¹⁰³ The FASB's original deliberations led to six statements. See generally ELEMENTS OF FIN. STATEMENTS—A REPLACEMENT OF FASB CONCEPTS STATEMENT NO. 3 (INCORPORATING AN AMENDMENT OF FASB CONCEPTS STATEMENT NO. 2), Statement of Fin. Accounting Concepts No. 6 (Fin. Accounting Standards Bd. 1985), available at <http://www.fasb.org/pdf/con6.pdf>; RECOGNITION AND MEASUREMENT IN FIN. STATEMENTS OF BUS. ENTERS., Statement of Fin. Accounting Concepts No. 5 (Fin. Accounting Standards Bd. 1984), available at <http://www.fasb.org/pdf/con5.pdf>; OBJECTIVES OF FIN. REPORTING BY NONBUSINESS ORGS., Statement of Fin. Accounting Concepts No. 4 (Fin. Accounting Standards Bd. 1980), available at <http://www.fasb.org/pdf/con4.pdf>; ELEMENTS OF FIN. STATEMENTS OF BUS. ENTERS., Statement of Fin. Accounting Concepts No. 3 (Fin. Accounting Standards Bd. 1980), available at <http://www.fasb.org/pdf/con3.pdf>; QUALITATIVE CHARACTERISTICS

3. The FASB and Agency Theory

The structural succession of the CAP to the APB to the FASB reflects the twentieth-century evolution of thinking about administrative agency design. Originally, agency discretion was not seen as problematic.¹⁰⁴ In Richard Stewart's phrase, agencies were conceived as "transmission belts" that implemented legislative directives.¹⁰⁵ All one needed was an expert acting within his or her zone of competence and appropriate results would follow, with legislative oversight, bureaucratic structure, and popular opinion sufficing to assure compliance with legislative directives.¹⁰⁶ For instance, both the CAP and the APB operated on the assumption that standard-setting problems could be addressed adequately simply by applying professional expertise.¹⁰⁷

But more was needed to justify the delegation of rule-making discretion to agencies. Thus did the New Dealers restate the theory of the administrative agency to stress the interplay between the legislative mandate and the agency's expertise.¹⁰⁸ If the agency's goal was stated explicitly, the regulator's expertise solved the discretion problem.¹⁰⁹ Agency rule making became a trial and error process of applying neutral, expert knowledge to realize the stated goal.¹¹⁰ The rules emerged as a function of the expertise and the state of the world, supported by objective bases.¹¹¹ Thus generated, they could not be arbitrary. With the Conceptual Framework project inherited from the APB, the FASB drew on this approach, seeking to justify its independent exercise of discretion by articulating generally accepted goals that would determine specific accounting standards.¹¹²

OF ACCOUNTING INFO., Statement of Fin. Accounting Concepts No. 2 (Fin. Accounting Standards Bd. 1980) [hereinafter FASB, SFAC No. 2], available at <http://www.fasb.org/pdf/con2.pdf>; FASB, SFAC No. 1, *supra* note 36. The FASB also issued one later statement. USING CASH FLOW INFO. AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS, Statement of Fin. Accounting Concepts No. 7 (Fin. Accounting Standards Bd. 2000) [hereinafter FASB, SFAC No. 7], available at <http://www.fasb.org/pdf/con7.pdf>.

¹⁰⁴ See Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1675 (1975).

¹⁰⁵ *Id.*

¹⁰⁶ See *id.*

¹⁰⁷ See *supra* notes 49–73 and accompanying text.

¹⁰⁸ See Stewart, *supra* note 104, at 1672–73, 1678.

¹⁰⁹ See LANDIS, *supra* note 32, at 50–51, 98–99.

¹¹⁰ See *id.*; Stewart, *supra* note 104, at 1678.

¹¹¹ See LANDIS, *supra* note 32, at 98–99; Stewart, *supra* note 104, at 1678.

¹¹² See King & Waymire, *supra* note 29, at 585–86.

The post-war critique of the New Deal expertise model also influenced the structure of the FASB.¹¹³ Practical experience led to questions about the agency experts' independence.¹¹⁴ Critics charged that the experts unduly favored the interests of regulated parties—the same allegation of capture that had impaired the APB's credibility.¹¹⁵ The FASB's founders sought to cure this problem through formal separation from the accounting profession.¹¹⁶ The FASB's due process regime similarly mirrored the standard public law palliative for capture problems—containment of agency discretion through process rules.¹¹⁷ Agencies also had come to be seen as prone toward overregulation, ever more elaborating their systems of controls.¹¹⁸ The FASB therefore established a built-in advisory board that was assigned the job of overseeing its agenda.¹¹⁹

The FASB's founders drew the line when it came to a more fundamental objection to agency authority. The expertise model only works if there is a general consensus on the stated goal.¹²⁰ Its critics destabilized that assumption by questioning the very existence of an objective public interest available to channel and contain agency discretion.¹²¹ Under this pluralist view, agency rule making becomes a legislative and political process of balancing conflicting constituent interests in light of a legislative directive.¹²² It follows that legitimacy under this view depends on the agency's political responsiveness—the governance structure must afford interest groups a forum and assure consideration of their views.¹²³ And the more responsive the agency, the less serious the capture problem.¹²⁴ Agency design becomes a matter of mediating tensions under this view because the pluralist approach, carried to its logical conclusion, negates the independence

¹¹³ See Stewart, *supra* note 104, at 1684.

¹¹⁴ *Id.* at 1682.

¹¹⁵ See VAN RIPER, *supra* note 16, at 8; Stewart, *supra* note 104, at 1684.

¹¹⁶ See VAN RIPER, *supra* note 16, at 14.

¹¹⁷ See Stewart, *supra* note 104, at 1698–99.

¹¹⁸ See *id.* at 1685.

¹¹⁹ See CHATOV, *supra* note 51, at 234. The FASB did not inherit a third agency problem, limited resources, which could lead to an excessive reliance on the resources of regulated interests. See Stewart, *supra* note 104, at 1686. Rather, the FASB owed its existence to the SEC's decision not to devote its own resources to setting accounting standards. See Administrative Policy on Financial Statements, *supra* note 9, at 72,005.

¹²⁰ Stewart, *supra* note 104, at 1702; see LANDIS, *supra* note 32, at 50–51.

¹²¹ See Stewart, *supra* note 104, at 1683.

¹²² *Id.*

¹²³ Freeman, *supra* note 5, at 559–60.

¹²⁴ *Id.* at 560.

model.¹²⁵ The agency, albeit expert, merely functions as an aggregator of outside preferences.¹²⁶ This makes private standard setting particularly problematic, for such a political process arguably should be conducted in the public sector.¹²⁷

If the FASB's founders perceived this problem they did not admit it, because admission would have implied the abandonment of the enterprise and the remission of the standard-setting function to the SEC. The FASB's existence stemmed from its private constituents' desire to avoid the political and financial risks attending such a surrender of control.¹²⁸ So averse were they to a public outcome that they proved willing not only to vest agenda control in a nominally independent board, but also to pay for its expenses.

The FASB's founders, then, implicitly denied the pertinence of the pluralist critique, instead insisting on the New Deal expertise model's suitability and designing a board that would be responsive as a matter of process. The FASB founders felt no duty to balance constituent demands, which made the Conceptual Framework project's successful completion all the more important. With the Framework up and running in a context of general consensus, the FASB would perfectly embody the expertise model.¹²⁹ It would be a legitimate neutral actor rather than a political actor in an interest group game.¹³⁰ Things would not work out as projected, however.

B. *Public and Private Reproaches*

The FASB, charged with making the New Deal model work in a private standard-setting context, undertook its task at an unpropitious time.¹³¹ The Wall Street "go-go" years ended abruptly in 1973, and were followed by a spate of scandals.¹³² Shortcomings in accounting standards received some of the blame for these scandals, which put accounting on the Congressional reform agenda.¹³³ At the same time, the New Deal agency model was being intensely criticized from oppo-

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *See id.*

¹²⁸ *See infra* note 271 and accompanying text.

¹²⁹ *See* LANDIS, *supra* note 32, at 50–51; Mundstock, *supra* note 29, at 818.

¹³⁰ *See* Mundstock, *supra* note 29, at 818.

¹³¹ *See* VAN RIPER, *supra* note 16, at 7.

¹³² *Id.* at 7–8.

¹³³ Beresford, *supra* note 11, at 58.

site sides in public policy debates.¹³⁴ Progressives wanted more public responsiveness, while public choice commentators dismissed the whole agency project as a means to the end of private rent seeking.¹³⁵ The FASB faced both attacks as it went forward under the banners of relevance, reliability, and informational neutrality.¹³⁶

1. Public Interest

The founders' project of cabining the FASB in the New Deal model did not lack irony. In the eyes of progressive critics, the whole enterprise resulted from a typical agency malfunction by a leading exemplar of the New Deal legacy—the SEC.¹³⁷ The critics made a powerful case. It was clear to everybody that choices of accounting principles had significant allocative consequences, whatever the accounting profession's position as to whether GAAP followed from objective determinants and led to objective truths.¹³⁸ Neutral and transparent accounting principles did not exist.¹³⁹ A political characterization of the enterprise followed: accounting standard setting was a high-stakes game in which the setter had no alternative but to balance interests.¹⁴⁰ And, to the extent the standard setter resolved political rather than technical issues,¹⁴¹ its legitimacy depended on political responsiveness.¹⁴² It followed that independence was not a virtue, but a guarantee of irrelevance, isolation, and unaccountability.¹⁴³ The public interest was at stake and a responsible public body had never even made a considered decision on the matter.¹⁴⁴ The time had come to vest standard-setting authority in an agency directly responsible to Congress.¹⁴⁵

Nor, in any event, could the FASB be considered independent.¹⁴⁶ It depended on contributions from the preparers and auditors,

¹³⁴ See VAN RIPER, *supra* note 16, at 18–19.

¹³⁵ See Beresford, *supra* note 11, at 58, 60; Kirk, *supra* note 10, at 17.

¹³⁶ See Beresford, *supra* note 11, at 58; Kirk, *supra* note 10, at 17.

¹³⁷ CHATOV, *supra* note 51, at 8.

¹³⁸ See VAN RIPER, *supra* note 16, at 22–23.

¹³⁹ Mundstock, *supra* note 29, at 822.

¹⁴⁰ VAN RIPER, *supra* note 16, at 73–74.

¹⁴¹ Matters of measurement were considered to be technical issues, whereas the ultimate determination of the treatment was seen as a political matter. *Id.*

¹⁴² *Id.* at 22–23.

¹⁴³ Mundstock, *supra* note 29, at 820.

¹⁴⁴ CHATOV, *supra* note 51, at 7.

¹⁴⁵ See *id.* at 7–8.

¹⁴⁶ See VAN RIPER, *supra* note 16, at 14.

groups with high stakes in all of its outcomes.¹⁴⁷ A government board would do a better job of weighing the costs and benefits.¹⁴⁸

This public interest position got a public airing in Congress in 1976 when Senator Lee Metcalf's Committee on Government Operations held hearings and issued a blistering report.¹⁴⁹ The SEC, the Committee said, had delegated the standard-setting function to special interest groups, in particular the Big Eight accounting firms, which enjoyed disproportionate representation on the FAF and the FASB in addition to controlling funding and staffing.¹⁵⁰ To restore public confidence, the General Accounting Office needed to take over the function, the SEC having disqualified itself in the matter.¹⁵¹ Actors from the FAF and the FASB made their first trip to Washington to defend themselves at subsequent hearings.¹⁵² Happily, things quieted down by the time a bill finally reached the House floor.¹⁵³ The bill, which never reached a vote, would only have required the SEC to set the FASB's agenda, impose a timetable, and intervene with its own standards if the FASB were slow or issued unsatisfactory standards.¹⁵⁴

2. Public Choice

Public choice theory explains the behavior of public actors in terms of private incentives.¹⁵⁵ Agencies become the targets of rent-seeking interest groups, the agencies themselves constituting just another interest group.¹⁵⁶ Thus depicted, the agencies serve the demands of the groups while expanding their own operations and power bases.¹⁵⁷ During the FASB's early years, public choice theorists applied their considerable critical acumen to a new description of the evolution of accounting standards.¹⁵⁸

¹⁴⁷ See *id.*

¹⁴⁸ See Beresford, *supra* note 11, at 60.

¹⁴⁹ See generally THE ACCOUNTING ESTABLISHMENT, *supra* note 10.

¹⁵⁰ See *id.* at 1-2.

¹⁵¹ VAN RIPER, *supra* note 16, at 45.

¹⁵² See Kirk, *supra* note 10, at 18.

¹⁵³ See VAN RIPER, *supra* note 16, at 45.

¹⁵⁴ See Kirk, *supra* note 10, at 18.

¹⁵⁵ See Freeman, *supra* note 5, at 561-62.

¹⁵⁶ See *id.*

¹⁵⁷ See Baruch Lev, *Toward a Theory of Equitable and Efficient Accounting Policy*, 63 ACCT. REV. 1, 11 (1988).

¹⁵⁸ See Ross L. Watts & Jerold L. Zimmerman, *The Demand for and Supply of Accounting Theories: The Market for Excuses*, 54 ACCT. REV. 273, 277 (1979).

The public choice theorists' description follows from a picture of an unregulated economy in which managers have high-powered reputational incentives to disclose financial information voluntarily.¹⁵⁹ Given those incentives, accounting practice evolves so as to reduce agency costs if left unregulated.¹⁶⁰ Reporting practices vary with the context, depending on capital structure, monitoring costs, size, dispersion, and complexity.¹⁶¹ In contrast, in a regulated economy, individuals compete to use the government's coercive power to transfer wealth to themselves, arguing that the transfer is in the public interest to justify the results.¹⁶² Mandated accounting treatments serve just this purpose, as vested interests compete over them using neutrally phrased terms.¹⁶³

Under this public choice reading, the standard-setting enterprise is intrinsically infirm so long as the standards are mandated. If there are mandated standards, very little difference lies in the choice between a public and private agency—the FASB and the SEC both are seen as bad entities because they operate a mandatory disclosure system. The solution lies in the mandate's removal. At that point a private standard setter need not be a bad thing, for its existence and robustness would depend on free choices made by preparers and users.

Although this view has negative implications for the legitimacy of the FASB, the political implications are marginal.¹⁶⁴ The capture allegation made by the FASB's progressive critics is echoed, but not replicated, by public choice theorists. Here, capture implies wholesale deregulation with a consequent sacrifice of uniformity, not to mention total reliance on market correctives to align preparer incentives. The

¹⁵⁹ See *id.* at 275.

¹⁶⁰ *Id.* at 277.

¹⁶¹ See *id.*

¹⁶² *Id.* at 280–81.

¹⁶³ See Watts & Zimmerman, *supra* note 158, at 280–81; see also Ross L. Watts & Jerold L. Zimmerman, *Towards a Positive Theory of the Determination of Accounting Standards*, 53 ACCT. REV. 112, 118 (1978) (predicting that managers of large firms will seek accounting principles that understate returns in order to hide income from regulators, while small firms that are focused on incentive pay will do the opposite).

¹⁶⁴ For a similarly marginal line of attack from the private side of the public/private divide, see generally Orace Johnson, *Some Implications of the United States Constitution for Accounting Institution Alternatives*, 19 J. ACCT. RES. (SUPP.) 89 (1981) (arguing that financial reports are constitutionally protected speech). For trenchant comments, see generally Roberta S. Karmel, *Discussion of Some Implications of the United States Constitution for Accounting Institution Alternatives*, 19 J. ACCT. RES. (SUPP.) 120 (1981), and Edmund W. Kitch, *Discussion of Some Implications of the United States Constitution for Accounting Institution Alternatives*, 19 J. ACCT. RES. (SUPP.) 123 (1981).

FASB has faced more immediate problems in making its case for legitimacy.

C. Institutional Evolution

The FASB and the FAF have been tinkering with their process and structure ever since the Metcalf Report slapped down the charge of capture and posed a pluralist alternative.¹⁶⁵ The changes have almost uniformly pushed the FASB in the direction of greater public responsiveness.¹⁶⁶

1. Structural Modifications

The process started with a FAF review in the immediate wake of the Metcalf intervention.¹⁶⁷ The review led to measures that further separated the FASB from the large audit firms. Contributions from any single firm were capped at \$50,000 or one percent of the FASB budget.¹⁶⁸ The requirement that four of the seven board members be CPAs also was eliminated in favor of a weaker requirement that members have knowledge of accounting, finance, and business.¹⁶⁹ The supermajority voting requirement was replaced as a result.¹⁷⁰ The five-to-two rule followed from a desire to prevent the appearance of a dominant CPA voting coalition.¹⁷¹ With the removal of the CPA majority, a simple majority rule sufficed.¹⁷² In addition, the AICPA lost its veto over the selection of FAF trustees.¹⁷³ Sole nominating power was instead vested in a committee of representatives from the FAF's sponsoring organizations.¹⁷⁴ The FASAC received an independent chair and an expanded role.¹⁷⁵ Finally, sunshine replaced secrecy, as proceedings were opened and dissents and other records made public.¹⁷⁶ Future plans were to be published in periodic reports.¹⁷⁷

¹⁶⁵ See THE ACCOUNTING ESTABLISHMENT, *supra* note 10, at 1-2, 20-24; *infra* notes 167-197 and accompanying text.

¹⁶⁶ See *infra* notes 167-197 and accompanying text.

¹⁶⁷ VAN RIPER, *supra* note 16, at 46.

¹⁶⁸ *Id.* at 88.

¹⁶⁹ *Id.* at 86-87.

¹⁷⁰ *Id.* at 87.

¹⁷¹ *Id.*

¹⁷² VAN RIPER, *supra* note 16, at 87.

¹⁷³ See Kirk, *supra* note 10, at 19.

¹⁷⁴ VAN RIPER, *supra* note 16, at 86.

¹⁷⁵ *Id.* at 47, 87.

¹⁷⁶ *Id.* at 86.

¹⁷⁷ *Id.* at 46-47.

Thereafter, the FASB became a larger organization, mostly funded by the proceeds of its own publications.¹⁷⁸ More staff enhanced its ability to meet constant demands for “timely guidance” with technical bulletins.¹⁷⁹ In 1984, it formed a subsidiary organization to address interpretive questions arising under existing rules.¹⁸⁰ This Emerging Issues Task Force has fifteen seats, ten of which are filled by partners from accounting firms.¹⁸¹ Preparer representatives take three seats, and, significantly, three votes suffice to block a determination and force the matter to the FASB’s agenda.¹⁸²

Preparer demands rose to the fore in the 1980s.¹⁸³ They wanted better representation on the FASB itself and got it in 1985.¹⁸⁴ From then on, the FASB would be comprised of three CPAs, two representatives from preparers, one user representative, and an academic.¹⁸⁵ That same year, the AICPA ceded its ex officio trustee seat on the FAF to a preparer representative.¹⁸⁶ In 1990, preparer complaints about standards overload led to the reimposition of the five-to-two supermajority rule.¹⁸⁷

The AICPA thereafter continued to fade from the picture, strengthening the FASB’s independence.¹⁸⁸ The AICPA lost its majority of FAF seats when it emerged with five of the sixteen trustees in 1993.¹⁸⁹ In the wake of Enron and SOX, the AICPA also left the business of issuing authoritative accounting guidance for registered companies.¹⁹⁰ Interestingly, in 2002, the FAF took the occasion of the external shock of scandal to change the FASB’s voting rule back to the

¹⁷⁸ See *id.* at 15. This enhanced independence from constituents but created a different, more subtle public/private problem. For discussion, see Cunningham, *supra* note 31, at 323–28. By 2002, the FASB earned \$13.3 million from its publications as compared with \$3.9 million from contributions. *Id.* at 325.

¹⁷⁹ See VAN RIPER, *supra* note 16, at 107.

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.* The Emerging Issues Task Force (the “EITF”) was restructured in 2003 with the addition of two FASB members to its agenda committee and a provision for FASB ratification of EITF consensus positions. See Lawrence W. Smith, *The FASB’s Efforts Toward Simplification*, FASB REP., Feb. 28, 2005, at 2, 2.

¹⁸³ See VAN RIPER, *supra* note 16, at 126.

¹⁸⁴ See *id.*

¹⁸⁵ See *id.*

¹⁸⁶ See *id.*

¹⁸⁷ *Id.* at 164.

¹⁸⁸ See VAN RIPER, *supra* note 16, at 14–15.

¹⁸⁹ *Id.*

¹⁹⁰ See Smith, *supra* note 182, at 2.

four-to-three simple majority.¹⁹¹ In the post-Enron environment, the need for speed once again trumped the preparers' interest in agenda control.¹⁹²

The FASB's final and most emphatic move to the public side of the street occurred with the enactment of SOX in 2002.¹⁹³ SOX changed the framework of federal recognition of GAAP, requiring that a recognized standard setter be wholly funded by fees levied on reporting companies by the federal government.¹⁹⁴ The FASB duly applied for recognition.¹⁹⁵ Upon the SEC's approval of the application, the FASB became publicly funded and ceased collecting contributions.¹⁹⁶ Technically speaking, it is no longer beholden to its constituents.¹⁹⁷

2. Empirical Studies

The FASB attracts a great deal of academic attention. Its transparency and shifting voting rules,¹⁹⁸ along with the allegations that it has been captured,¹⁹⁹ make its proceedings an ideal subject for social scientists armed with statistical methodologies. Studies have looked for connections between the members' votes and prior affiliations, and found nothing significant.²⁰⁰ Nor have any dominant voting coalitions of former auditors or preparers appeared,²⁰¹ although some two-

¹⁹¹ See *FASB Voting Structure Streamlined*, LEADER'S EDGE, June 2002, at 3, 3.

¹⁹² See *id.*

¹⁹³ See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

¹⁹⁴ *Id.* § 108, 15 U.S.C. § 77s (Supp. III 2003).

¹⁹⁵ Cunningham, *supra* note 31, at 323.

¹⁹⁶ See *id.* The FASB is much richer as a result. See *id.* at 325. In 2004, federal support fees totaled \$25.3 million and publication net revenues \$13.05 million. See FIN. ACCOUNTING FOUND., ANNUAL REPORT 2005, at 35, 38 (2006), available at http://www.fasb.org/annualreport/FAF_2005_AR.pdf.

¹⁹⁷ Cunningham, *supra* note 31, at 324.

¹⁹⁸ See VAN RIPER, *supra* note 16, at 86-87.

¹⁹⁹ See THE ACCOUNTING ESTABLISHMENT, *supra* note 10, at 1-2.

²⁰⁰ See John C. McEnroe & Stanley C. Martens, *An Analysis of the FASB's Independence*, J. APPLIED BUS. RES., Winter 1996/1997, at 129, 131-32 (concluding that the FASB's members vote independently and updating an earlier study). Interestingly, a study of the APB yields the same result. See D. Paul Newman, *Coalition Formation in the APB and the FASB: Some Evidence on the Size Principle*, 56 ACCT. REV. 897, 908 (1981).

²⁰¹ See, e.g., Newman, *supra* note 200, at 897-98 (surveying the literature); D. Paul Newman, *An Investigation of the Distribution of Power in the APB and the FASB*, 19 J. ACCT. RES. 247, 261 (1981) [hereinafter Newman, *Investigation of the Distribution of Power*] (demonstrating that the observed influence of Big Eight representatives has been no greater than that of non-Big Eight representatives).

member voting pairs do show up in the data.²⁰² (Here a caveat must be noted—any coalition activity respecting selection of agenda items is unobservable.²⁰³) The studies also have shown that the voting rules matter: more standards get set under the 4–3 rule than under the 5–2 rule, with the supermajority significantly slowing the time to promulgation.²⁰⁴ Finally, self-interest clearly motivates commenting companies²⁰⁵ and lobbying impacts the terms of the standards.²⁰⁶ However, the FASB has done fairly well with respect to resisting undue influence by the large accounting firms.²⁰⁷ In fact, one study has concluded that the FASB has not been captured, at least in any empirically verifiable sense.²⁰⁸

²⁰² See Sharon M. Moody & Dale L. Flesher, *Analysis of FASB Voting Patterns: Statement Nos. 1–86*, 1 J. ACCT. AUDITING & FIN. 319, 328–29 (1986) (finding coalition evidence in cases where the pronouncement passes by a 4–3 vote); Frank H. Selto & Hugh D. Grove, *The Predictive Power of Voting Power Indices: FASB Voting on Statements of Financial Accounting Standards Nos. 45–69*, 21 J. ACCT. RES. 619, 622 (1983) (finding that one two-vote coalition persisted, but that it did not wield voting power beyond that provided by its proper share of the votes).

²⁰³ See Newman, *Investigation of the Distribution of Power*, *supra* note 201, at 249 (noting that a powerful Big Eight coalition block could block agenda items so that an issue reached the agenda only with the coalition divided).

²⁰⁴ See William R. Pasewark, *The Effect of Imposed Voting Requirements on FASB Decisions*, 15 J. ACCT. AUDITING & FIN. 75, 84 (2000) (showing that the FASB produced 3.80 pronouncements per year under supermajority provisions and 6.78 per year under a simple majority rule). For simulations of voting patterns, see Thomas D. Fields & Ronald R. King, *Voting Rules for the FASB*, 11 J. ACCT. AUDITING & FIN. 99, 111, 114 (1996) (showing that a supermajority maintains the status quo more often given imperfect information but that the margin of victory is unlikely to change under either requirement); R.R. King, *An Experimental Investigation of Supermajority Voting Rules: Implications for the Financial Accounting Standards Board*, 25 J. ECON. BEHAV. & ORG. 197, 206–15 (1994) (showing that a laboratory experiment applying simple majority and supermajority voting rules reached inconclusive results).

²⁰⁵ See Michael Ettredge et al., *Competitive Harm and Companies' Positions on SFAS No. 131*, 17 J. ACCT. AUDITING & FIN. 93, 107 (2002) (showing positions motivated by interests implicated by projected costs and potential competitive harm).

²⁰⁶ See Sally M. Schultz & Joan Hollister, *Lobbying FASB on Accounting for Investments*, 19 J. APPLIED BUS. RES. 85, 88–92 (2003) (showing the effect of the notice and comment process on SFAS No. 115).

²⁰⁷ See Paul R. Brown, *A Descriptive Analysis of Select Input Bases of the Financial Accounting Standards Board*, 19 J. ACCT. RES. 232, 233–45 (1981) (evaluating the relationship between FASB decisions and constituent lobbying and yielding negative results, supporting the hypothesis that the FASB does not consistently position itself with any one external constituent).

²⁰⁸ See Hussein & Katz, *supra* note 17, at 61 (concluding that structural factors, particularly mutual resistance, constrain the competing constituents from dominating the FASB).

D. Summary

Although the FASB's structure has been modified to assure more public responsiveness, there has been no break with the classical independence model.²⁰⁹ Indeed, compared to the SEC, the FASB arguably remains the more independent agency. The political branches of the federal government state the mission and select the members of the SEC. With the FASB, on the other hand, the political branches only wield veto power—they can put it out of business or they (or their SEC nominees) can selectively reject its output, but they otherwise do not control it.²¹⁰ The FASB emerges in a position similar to that of many public agencies: regulating within the parameters of stated goals, remaining subject to loose oversight from political higher-ups, and taking private preferences into account without permitting them to determine results.²¹¹

We have seen the FASB maintain apparent independence, deflect a pluralist challenge to its legitimacy, survive, and prosper. It has done all of this against a background of constant complaint. Critics have accused the FASB of excessive delay, excessive complexity, and excessive reliance on rules throughout its history.²¹² The question as to the FASB's legitimacy accordingly remains to be answered.

II. DECISION USEFULNESS

This Part focuses on the Conceptual Framework's designation of the users as the interest to be served, a choice that had as much to do with the creation of a viable agency framework as with the articulation of a coherent accounting theory.²¹³ For the New Deal model to work, the FASB needed a focused goal.²¹⁴ To get one, it broke with past accounting theory to raise external transparency—"decision usefulness" for the users—over internal control as the system's goal.²¹⁵

This has had three consequences. The first is substantive legitimacy, discussed in Section A.²¹⁶ The user tilt makes plausible the FASB's claim to legitimacy as an independent expert. The goal of deci-

²⁰⁹ See VAN RIPER, *supra* note 16, at 9, 86–87; Mundstock, *supra* note 29, at 818.

²¹⁰ See VAN RIPER, *supra* note 16, at 9, 14.

²¹¹ See Freeman, *supra* note 5, at 560.

²¹² See Beresford, *supra* note 11, at 60–61.

²¹³ See FASB, SFAC No. 1, *supra* note 36, § 34.

²¹⁴ See LANDIS, *supra* note 32, at 50–51.

²¹⁵ See *infra* notes 225–249 and accompanying text.

²¹⁶ See *infra* notes 219–265 and accompanying text.

sion usefulness is generally accepted as a policy matter and makes sense as a matter of economic theory. It aligns the FASB with information economics, which affords the most cogent justification for a centralized, mandated standard setting for financial reports. Section B addresses the second consequence: with decision usefulness, the Conceptual Framework embeds a normative preference for one of the FASB's leading private constituents, users and markets, over the other, preparers and managers.²¹⁷ Although this caused constant and costly political problems, it also yielded ancillary benefits. User support, or at least acquiescence, counterbalances management opposition. At the same time, no one can accuse the FASB of being a corporate tool. It instead amounts to a subagent of its public agency government overseer, the SEC. Section C takes up this agency relationship.²¹⁸ The SEC's delegation of standard-setting authority to the FASB for the most part has served its own public purposes in a cost-effective manner.

A. The Conceptual Framework, Decision Usefulness, and Policy Legitimacy

The Conceptual Framework is widely regarded as a theoretical failure, particularly with respect to the critical topic of revenue recognition and measurement.²¹⁹ It did not silence critics who contend that standard setting for financial reports implies a political choice between competing constituent interests.²²⁰ Nor did it succeed in determining the results of standard-setting exercises.²²¹ Actors at the FASB defend it with faint praise as a useful exercise in philosophical discipline²²² or a "relatively consistent body of standards" to which the FASB "pay[s] attention."²²³ And, to the extent that the Conceptual Framework's precepts actually have shaped the FASB's standards, critics charge that they skew results toward formalism and artificiality and sacrifice flexibility and responsiveness.²²⁴

²¹⁷ See *infra* notes 266–296 and accompanying text.

²¹⁸ See *infra* notes 297–318 and accompanying text.

²¹⁹ See Zeff, *supra* note 52, at 60.

²²⁰ See VAN RIPER, *supra* note 16, at 10–11; Joshua Ronen & George Sorter, *Reflections on "Reflections on FASB's Conceptual Framework for Accounting and on Auditing,"* 4 J. ACCT. AUDITING & FIN. 67, 69 (1989).

²²¹ See VAN RIPER, *supra* note 16, at 80.

²²² *Id.*

²²³ Beresford, *supra* note 11, at 61.

²²⁴ See Homer Kripke, *Reflections on the FASB's Conceptual Framework for Accounting and on Auditing*, 4 J. ACCT. AUDITING & FIN. 3, 49–50 (1989).

1. Decision Usefulness

Some assert that the Conceptual Framework accomplished one important thing,²²⁵ set out in a single unprepossessing sentence in Statement of Financial Accounting Concepts No. 1: "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions."²²⁶ This concept, known as "decision usefulness," seems like an obvious point, but it was controversial when promulgated in 1978.²²⁷ Only thirty-seven percent of the comments received on the point were favorable, and sixty-one percent of the comments came from preparers.²²⁸

The objecting preparers had their reasons for opposing the provision in Statement of Financial Accounting Concepts No. 1.²²⁹ Financial reporting in fact serves two purposes: it provides external transparency and serves as a part of a rational system of internal management.²³⁰ Historically, both purposes had been bound together under the rubric of "stewardship,"²³¹ which emphasized the manager's duty to maintain the value of assets in addition to its duty to report results to owners and creditors.²³² The value-maintaining preparer was seen as a user and accorded an equal place at the table with owners and creditors.²³³ Indeed, management asserted that stewardship implied its own primacy, positing a community of interest between itself and the firm's long-term shareholders as against an outside financial market made up of speculators looking to turn quick profits.²³⁴

The Conceptual Framework, even as it paid lip service to the stewardship concept,²³⁵ broke with history by removing management from the group of recognized users.²³⁶ Although the Conceptual Framework asserted that the "role of financial reporting requires it to

²²⁵ John C. Burton, *A Commentary on the Reflections of Homer Kripke*, 4 J. ACCT. AUDITING & FIN. 79, 80 (1989).

²²⁶ FASB, SFAC No. 1, *supra* note 36, § 34.

²²⁷ See VAN RIPER, *supra* note 16, at 20.

²²⁸ See *id.*

²²⁹ See *id.*

²³⁰ See Watts & Zimmerman, *supra* note 158, at 296-97.

²³¹ See *id.* at 296.

²³² *Id.* at 295-97.

²³³ See *id.* at 296.

²³⁴ VAN RIPER, *supra* note 16, at 21.

²³⁵ FASB, SFAC No. 1, *supra* note 36, §§ 50-53.

²³⁶ *Id.* § 27; see also *id.* § 32 (asserting that standards that satisfy the objective of usefulness to investors should be "useful to all who are interested in an enterprise's future capacity to pay").

provide evenhanded, neutral, or unbiased information," neutrality concerned only the usefulness of information reported.²³⁷ It had no bearing on the relative treatment of constituent interests in the standard-setting process.²³⁸ This posture, taken together with the Conceptual Framework's objectives of comparability across different preparers' reports and consistency across time within a preparer's reports, implied significant constraints on management's discretion to choose treatments (whether in view of a congenial bottom-line result or as the result of an internal cost-benefit analysis).²³⁹ Based on decision usefulness, management would bear the burden of proof in justifying its favored treatments in FASB proceedings.²⁴⁰

For the FASB, decision usefulness meant more than a normative choice between the markets and the preparers. It completed the project of adopting the independent expertise model and foreclosing the pluralist alternative. Recall that the expertise model only works if the agency pursues an overriding goal.²⁴¹ If the goal remains contestable, the agency ends up with the political task of accommodating conflicting interests as it pursues multiple goals.²⁴² Decision usefulness, left within the stewardship framework, would have cast the FASB into a world of multiple users with varied and conflicting preferences.²⁴³ The FASB's interest in maintaining its own independence foreclosed the possibility of a neutral approach to constituent interests.²⁴⁴

Unsurprisingly, the FASB has adhered to decision usefulness over time. Its actors believe that so doing keeps them above politics.²⁴⁵ In their view, the FASB exists to produce consistent standards with a conceptual underpinning.²⁴⁶ To take away the underpinning and open the floor to all legitimate concerns would pull it away from its mission.²⁴⁷ So far as the FASB is concerned, such an open-ended process would be better undertaken by a public agency.²⁴⁸

²³⁷ See *id.* § 33.

²³⁸ See *id.*

²³⁹ See *id.*

²⁴⁰ See Hussein & Katz, *supra* note 17, at 70, 77; see also King & Waymire, *supra* note 29, at 591 (stressing the importance to the market of consistent treatment and consequent constraints on management discretion).

²⁴¹ See LANDIS, *supra* note 32, at 50–51.

²⁴² Stewart, *supra* note 104, at 1702.

²⁴³ See Lev, *supra* note 157, at 2, 13.

²⁴⁴ See *id.*

²⁴⁵ See Beresford, *supra* note 11, at 61.

²⁴⁶ See *id.*

²⁴⁷ See *id.*

²⁴⁸ *Id.* at 57.

Note that the FASB can proceed above politics and hew to the independent expert model only because it made a political decision *ex ante* in its own Conceptual Framework. Unsurprisingly, staying above politics pursuant to a political strategy has meant endless political problems, as the succeeding Sections show.²⁴⁹ At the same time, the institutional benefits to the FASB have far exceeded the political costs.

2. Policy Legitimacy

The Conceptual Framework's embedding of decision usefulness as the standard-setting goal, however useful as a matter of agency design, would have availed the FASB nothing had it not also imported policy legitimacy. Fortunately for the FASB, it has done exactly that.

The preparers had more than historical precedent (and their own self-interest) going for them in advocating the goal of stewardship. They also had a powerful economic argument, which put a cost-benefit gloss on the pluralist, interest-balancing view of accounting standard setting.²⁵⁰ The argument stresses the costs of disclosure.²⁵¹ These include not only out-of-pocket compliance costs, but the potential for competitive disadvantage to the preparer and a wider discouragement of innovation and risk taking.²⁵² As to a particular proposed standard, the more current the information reported, the more detailed the report, the more focused on the profitability of a narrow profit line, and the smaller the number of outside interests finding the disclosure useful, the greater the likelihood that the disclosure implies competitive disadvantage and would fail to pass cost-benefit scrutiny.²⁵³ Public values also come into play: because the requisite cost-benefit judgments would necessarily be subjective, the legitimate standard setter would have to arrive at a "fair and equitable" balancing of interests.²⁵⁴ In this way, the preparers rolled together stewardship, pluralism, managerialism, and public welfare in a tidy package.

Based on decision usefulness, a two-part reply could be made for the FASB. First, information is a public good that will be underpro-

²⁴⁹ See *infra* notes 266–296 and accompanying text.

²⁵⁰ See R.K. MAUTZ & WILLIAM G. MAY, FINANCIAL DISCLOSURE IN A COMPETITIVE ECONOMY: CONSIDERATIONS IN ESTABLISHING FINANCIAL ACCOUNTING STANDARDS 1–4 (1978) (presenting a project of the Financial Executives Research Foundation).

²⁵¹ See *id.* at 1.

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ *Id.* at 4. It was argued that the FASB should detail the costs and benefits of each standard in an "economic impact statement." *Id.* at 7.

vided absent regulation.²⁵⁵ More particularly, the standards reduce the social costs of information asymmetries, which include high transaction costs and thin capital markets with low liquidity.²⁵⁶ Although the capital markets certainly could function with low information, they would not be robust.²⁵⁷ With different investors having access to different levels of information, the fact that information shows increasing returns to scale implies that some investors would be endowed with monopolistic returns and other, less well-endowed investors would withdraw from the market.²⁵⁸ Bid-ask spreads would widen, transaction costs would rise, and volume would drop.²⁵⁹ The user-based regime, in short, enhances allocative efficiency.²⁶⁰

Second, absent a centralized standard setter producing user-directed and mandated GAAP, reporting would suffer from the structural imbalances that otherwise impair the corporate governance system.²⁶¹ We have, after all, a situation of separated ownership and control. The users, as dispersed shareholders, have no incentive to produce standards.²⁶² Indeed, absent centralized standards, a free rider problem would inhibit innovation by preparers and auditors and lead to underinvestment in standards.²⁶³ Finally, if the development of treatments were remitted to the joint discretion of preparers and auditors, management would have an advantage in getting rule innovations to suit its interests, causing information asymmetries.²⁶⁴

Taken together, the two justifications replicate those supporting the federal mandatory disclosure system. The FASB could not ask for a better defense than that,²⁶⁵ and could not have gotten by with anything less. Note that at the same time the preparers' cost-benefit argument is countered without being confronted.

²⁵⁵ The Conceptual Framework takes care to note this. See FASB, SFAC No. 2, *supra* note 103, § 135.

²⁵⁶ Lev, *supra* note 157, at 9.

²⁵⁷ See *id.* at 8–9.

²⁵⁸ *Id.* at 6–7.

²⁵⁹ *Id.* at 8.

²⁶⁰ See *id.* at 4–9.

²⁶¹ See King & Waymire, *supra* note 29, at 594–96.

²⁶² *Id.* at 595.

²⁶³ *Id.*

²⁶⁴ See *id.* at 594–95.

²⁶⁵ See Beresford, *supra* note 11, at 61 (pointing out that the United States has the world's finest financial system).

B. *Management Opposition*

Even as the FASB emerged as a plausible imitation of an expertise-based, independent public agency, it differed in one significant way. With a public agency, the elected legislature states the goal, importing political as well as policy legitimacy at the outset.²⁶⁶ With the FASB, the founders delegated the goal-setting function to the agency itself.²⁶⁷ The FASB then set the goal with a view to its own institutional viability, while traversing the interests of a primary constituent.²⁶⁸ Unsurprisingly, the preparers dissented and the goal failed to attain a general consensus.²⁶⁹ Dissent ripened into opposition when the FASB proceeded to take seriously its own independence and set an aggressive agenda of standards reform.²⁷⁰ The preparers had signed on during the 1970s, when the political environment made public standard setting by actors hostile to corporate interests a cognizable possibility.²⁷¹ That threat receded after 1980, and with it management's disposition to cooperate with the FASB.²⁷²

The FASB made enemies in boardrooms with a trio of initiatives in the 1970s. First, it changed the rules on the recognition of loss contingencies to block accruals before such time as the loss reasonably could be estimated.²⁷³ This inhibited management's elbow room to indulge in the time-honored practice of smoothing income across accounting periods.²⁷⁴ Second, taking a fair value point of view that was itself anathema to management, the FASB tightened the rules on portfolio securities and troubled loans, forcing the banks to take write-downs during a recessionary period.²⁷⁵ Third, the FASB went after the oil and gas industry, which had been happily capitalizing and

²⁶⁶ See LANDIS, *supra* note 32, at 50–51.

²⁶⁷ See VAN RIPER, *supra* note 16, at 77.

²⁶⁸ See *id.*

²⁶⁹ *Id.* at 75–76, 78.

²⁷⁰ See *id.* at 119.

²⁷¹ See *id.* at 9–10. The American Management Association had argued for a uniform standard setter as early as 1932. *Id.* at 5. But in the hot stock market of the 1960s, managers became more appreciative of the benefits of flexible accounting. Zeff, *supra* note 52, at 58.

²⁷² See VAN RIPER, *supra* note 16, at 70, 119.

²⁷³ See *generally* ACCOUNTING FOR CONTINGENCIES, Statement of Fin. Accounting Standards No. 5 (Fin. Accounting Standards Bd. 1975), available at <http://www.fasb.org/pdf/fas5.pdf>.

²⁷⁴ See VAN RIPER, *supra* note 16, at 31.

²⁷⁵ See *generally* ACCOUNTING FOR CERTAIN MARKETABLE SEC., Statement of Fin. Accounting Standards No. 12 (Fin. Accounting Standards Bd. 1975), available at <http://www.fasb.org/pdf/fas12.pdf>.

amortizing all drilling costs.²⁷⁶ The FASB wanted immediate and full cost write-offs.²⁷⁷ The industry argued that this would chill investment in exploration and applied political pressure that eventually resulted in an SEC limitation on the treatment's application.²⁷⁸

The FASB continued to anger corporate boards in the 1980s, when it addressed corporate obligations to retired employees under defined benefit pension plans.²⁷⁹ The FASB wanted these booked as balance sheet liabilities.²⁸⁰ The preparers resisted successfully, arguing that such a treatment would mean the end of employee pension benefits.²⁸¹

In the 1990s and 2000s, management stock options became the next hot button issue when the FASB proposed that the options' economic cost to the shareholders be assessed at fair value on the grant date and expensed over the vesting period.²⁸² The preparers, again arguing that the reform would inhibit investment and innovation, resisted in Congress, procuring a Senate resolution grounded in their pluralist, cost-benefit view of financial standard setting.²⁸³ The FASB, said the Senate, should confront the economic consequences of its proposed standards.²⁸⁴ A bill introduced contemporaneously would

²⁷⁶ See generally FIN. ACCOUNTING AND REPORTING BY OIL AND GAS PRODUCING COS., Statement of Fin. Accounting Standards No. 19 (Fin. Accounting Standards Bd. 1977), available at <http://www.fasb.org/pdf/fas19.pdf>.

²⁷⁷ See generally *id.*; see also generally SUSPENSION OF CERTAIN ACCOUNTING REQUIREMENTS FOR OIL AND GAS PRODUCING COS. (AN AMENDMENT OF FASB STATEMENT NO. 19), Statement of Fin. Accounting Standards No. 25 (Fin. Accounting Standards Bd. 1979), available at <http://www.fasb.org/pdf/fas25.pdf>.

²⁷⁸ See VAN RIPER, *supra* note 16, at 67–70; Robert T. Sprouse, *Discussion of the SEC's Influence on Accounting Standards: The Power of the Veto*, 19 J. ACCT. RES. 165, 167 (1981) (explaining that the SEC's intervention was not technically a veto). The SEC cited national policy concerns respecting the measurement of proven and probable reserves. See Adoption of Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities, Exchange Act Release No. 33-5966, Public Utility Holding Company Act Release No. 34-15108, Investment Company Act Release No. 35-20688, 15 SEC Docket 929 (Aug. 31, 1978).

²⁷⁹ See generally EMPLOYERS' ACCOUNTING FOR PENSIONS, Statement of Fin. Accounting Standards No. 87 (Fin. Accounting Standards Bd. 1985) [hereinafter FASB, SFAS No. 87], available at <http://www.fasb.org/pdf/fas87.pdf>; VAN RIPER, *supra* note 16, at 118.

²⁸⁰ See VAN RIPER, *supra* note 16, at 118. The FASB settled for a modification of the existing system. See generally FASB, SFAS No. 87, *supra* note 279.

²⁸¹ See VAN RIPER, *supra* note 16, at 118–22.

²⁸² See *id.* at 155.

²⁸³ See Michael H. Granof & Stephen A. Zeff, *Unaccountable in Washington*, N.Y. TIMES, Jan. 23, 2002, at A19.

²⁸⁴ See *id.*

have conditioned the effectiveness of new standards on an SEC majority vote.²⁸⁵ The FASB backed down and shelved the project.²⁸⁶

The FASB, setting its agenda independently in this way, has pursued decision usefulness in disregard of constituent opposition. The preparers view this as a betrayal, a classic case of an unresponsive agency promulgating regulations for their own sake.²⁸⁷ Neither the FASB notice and comment process nor the FASAC advisory process has proved tractable for the preparers.²⁸⁸ They complain and get occasional concessions, but the FASB continues to promulgate standards that they oppose.²⁸⁹ The preparers, however, do not argue for a public standard setter.²⁹⁰ They instead want to contain the private agency with an agenda control mechanism: an oversight board with power to block agenda items and force revision of existing standards.²⁹¹ They have pressed for this at the FAF,²⁹² at the SEC,²⁹³ and in Congress,²⁹⁴ making the pluralist case for public accountability without success. Whether this implies a democratic deficit is another question. The preparers hardly lack influence or political access. They have wielded their political muscle to block proposed standards, secured two of the FASB's seven seats, and, at least for a while, procured a supermajority voting regime.²⁹⁵ Meanwhile, the FASB emerges from this four-decade back-and-forth with an enviable reputation for independence.²⁹⁶

C. Public Oversight

The relationship between a public agency and a delegated private standard setter has been usefully described in private contractual terms:

²⁸⁵ Beresford, *supra* note 11, at 57.

²⁸⁶ See Granof & Zeff, *supra* note 283. The FASB famously returned to the matter in 2004, when the post-Enron political winds blew more favorably. See generally SHARE-BASED PAYMENT (REVISED 2004), Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd. 2004), available at <http://www.fasb.org/pdf/fas123r.pdf>.

²⁸⁷ See Beresford, *supra* note 11, at 57 (citing complaints from John Reed, Chief Executive Officer of Citibank).

²⁸⁸ See VAN RIPER, *supra* note 16, at 99, 126; Beresford, *supra* note 11, at 60–61.

²⁸⁹ See VAN RIPER, *supra* note 16, at 98, 118–31, 183.

²⁹⁰ See *id.* at 102; Beresford, *supra* note 11, at 59.

²⁹¹ See VAN RIPER, *supra* note 16, at 119–23, 140; Beresford, *supra* note 11, at 57.

²⁹² See VAN RIPER, *supra* note 16, at 119–23 (describing the Business Roundtable's Accounting Task Force); *id.* at 126–27 (describing the preparer's argument for a return to secrecy that would ease the path for back room logrolling).

²⁹³ *Id.* at 140 (recounting John Reed's proposal to David Ruder).

²⁹⁴ Beresford, *supra* note 11, at 57.

²⁹⁵ VAN RIPER, *supra* note 16, at 126, 150, 164.

²⁹⁶ See Beresford, *supra* note 11, at 61.

the public agency, like a firm, decides to “make or buy.”²⁹⁷ Buying makes sense if the value of the resources conserved through reliance on a private entity exceeds the relationship’s ancillary costs.²⁹⁸ The costs mount if the delegate’s incentives work at cross purposes with the agency’s pursuit of its public mission.²⁹⁹ If the delegate has an advantage of information and expertise and the agency’s monitoring resources are limited, then the agency can lose control of the outcome.³⁰⁰ The undermonitored delegate can hold up its public principal.³⁰¹

If we fill in the SEC as the principal and the FASB as the delegate, the result provides an excellent example of a successful public-to-private contract. Two factors explain the success. The first stems from the Conceptual Framework and decision usefulness. Together they effectively align the FASB’s institutional goal with the SEC’s mission of investor protection.³⁰² Indeed, as between the two agencies, the FASB now is the better-aligned of the two. Under the National Securities Markets Improvement Act of 1996, SEC rulemaking now labors under the same marching orders that the preparers once sought for the FASB: the SEC is required to take “efficiency, competition, and capital formation” into account in addition to investor protection.³⁰³

The alignment, thus set in theory, works in practice because the FASB’s appointments structure and rules of independence assure that its members pursue its formal mission rather than constituent or personal interests. The alignment makes the SEC useful to the FASB, as well as making the FASB useful to the SEC. To contain the FASB politically, the preparers must sustain the burden of an appeal to Congress, as the SEC has proved an uncongenial lobbying alternative on repeated occasions.³⁰⁴ The users, silently seconding the point, have remained quiescent throughout the FASB’s turbulent political history.³⁰⁵

²⁹⁷ See Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 DUKE L.J. 389, 390 (2003).

²⁹⁸ See *id.* at 405.

²⁹⁹ *Id.*

³⁰⁰ See *id.*

³⁰¹ *Id.* at 406, 410–11 (citing the SEC’s relationship with the FASB as an example).

³⁰² See FSAB, SFAC No. 1, *supra* note 36, § 34; VAN RIPER, *supra* note 16, at 141.

³⁰³ See National Securities Markets Improvement Act of 1996 § 106(a)(2), 15 U.S.C. § 77b(b) (2000). For a case invalidating an SEC rule on this ground, see *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005).

³⁰⁴ See VAN RIPER, *supra* note 16, at 140–46. John Reed, acting for a committee of preparers on the agenda control initiative, unsuccessfully attempted to influence both David Ruder and Richard Breeden in succession. *Id.* A later SEC chair, Harvey Pitt, might have been an exception, but was forced to resign before he got the chance.

³⁰⁵ See *id.* at 98.

The second factor in the success of the public-to-private contract between the SEC and the FASB is shared expertise.³⁰⁶ Although the SEC values the resources (both economic and political)³⁰⁷ saved by outsourcing the standard-setting function, it nonetheless makes a significant ongoing internal investment in accounting expertise.³⁰⁸ Monitoring of the FASB's agenda, priorities, and emerging positions by the SEC Office of the Chief Accountant occurs in the ordinary course and proceeds cooperatively.³⁰⁹ The SEC's accountants and the FASB announced a policy of mutual nonsurprise in 1974, and have since held to it.³¹⁰ As in all effective principal-agent relationships, the principal also wields a big stick.³¹¹ The FASB's authority depends on SEC certification, and because the SEC maintains its own standard-setting capacity, it can overrule the FASB by taking a matter into its own hands.³¹² It has done this rarely, however.³¹³ The two most prominent cases, the oil and gas drilling expense matter³¹⁴ and accounting for inflation,³¹⁵ occurred during the FASB's early history, with constituent pressure coming to bear both times.³¹⁶ The most recent case of note, accounting for derivatives, involved an extended back-and-forth on a complex matter, with the FASB proving responsive over time.³¹⁷ In the more usual case, threats and suggestions suffice to keep the two agencies' agendas and priorities in synchrony.³¹⁸

³⁰⁶ For a discussion of the SEC's role as an accounting standard setter, see generally Matthew J. Barrett, *The SEC and Accounting, in Part Through the Eyes of Pacioli*, 80 NOTRE DAME L. REV. 837 (2005).

³⁰⁷ See Mundstock, *supra* note 29, at 834.

³⁰⁸ See Zeff, *supra* note 52, at 60–61, 63.

³⁰⁹ See *id.* at 60–61; see also SEC, Office of the Chief Accountant, <http://www.sec.gov/about/offices/oca/ocaaccount.htm> (last visited Nov. 9, 2006) (listing selected Staff Bulletins issued by the Office).

³¹⁰ See VAN RIPER, *supra* note 16, at 26–27.

³¹¹ See Barrett, *supra* note 306, at 868.

³¹² See *id.*; Cunningham, *supra* note 31, at 323.

³¹³ See Barrett, *supra* note 306, at 868.

³¹⁴ See VAN RIPER, *supra* note 16, at 69–70.

³¹⁵ See Zeff, *supra* note 52, at 59. Incidences of overruling were more common with the CAP and the APB. *Id.* at 58–59.

³¹⁶ See VAN RIPER, *supra* note 16, at 56–69; Hussein & Katz, *supra* note 17, at 74. In the inflation accounting case, the auditors weighed in against the FASB. See Hussein & Katz, *supra* note 17, at 74.

³¹⁷ The SEC intervened with its own disclosure requirements between the promulgation of Statement of Financial Accounting Standards No. 119 and Statement of Financial Accounting Standards No. 133. See Proposed Amendments to Require Disclosure of Accounting Policies for Derivative Financial Instruments, Exchange Act Release No. 33–7250, Investment Company Act Release No. 34–36643, 60 SEC Docket 2575 (Dec. 28, 1995); Press Release, Sec. & Exch. Comm., SEC to Consider Requiring Disclosures About Deriva-

D. Summary

The FASB and its founders sought to legitimate private standard setting by adopting the New Deal model of the independent, expert agency. Much like an independent public agency, they encountered a range of pluralist, public interest objections to the FASB's exercises of regulatory discretion. But faithful adherence to the New Deal playbook worked well in the long run. This happened in no small measure because the FASB put itself on history's winning side with decision usefulness. It thereby aligned itself not only with the SEC, but also with the broader economic shift away from managerialism and toward capital market governance under the norm of shareholder value.

III. RULES AND PRINCIPLES

This Part addresses the standards themselves. We have seen that the preparers' lack of agenda control triggers the charge of "standards overload."³¹⁹ The preparers also complain of excessive complexity, but only when they dislike the substance of the treatment under discussion.³²⁰ Complexity bothers them less when the substance is congenial.³²¹ The complaint of excess complexity, as mooted more gen-

tives and Market Risk (Jan. 28, 1997), *available at* 1997 WL 34093. *See generally* ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, Statement of Fin. Accounting Standards No. 133 (Fin. Accounting Standards Bd. 1998), *available at* <http://www.fasb.org/pdf/fas133.pdf>; DISCLOSURE ABOUT DERIVATIVE FIN. INSTRUMENTS AND FAIR VALUE OF FIN. INSTRUMENTS, Statement of Fin. Accounting Standards No. 119 (Fin. Accounting Standards Bd. 1994), *available at* <http://www.fasb.org/pdf/fas119.pdf>.

³¹⁸ For theoretical treatments of the relationship, see Nahum D. Melumad & Toshiyuki Shibano, *The Securities and Exchange Commission and the Financial Accounting Standards Board: Regulation Through Veto-Based Delegation*, 32 J. ACCT. RES. 1, 2, 7-14 (1994) (setting out a formal veto model showing that wider delegation by the SEC would enhance the effectiveness of the process); D. Paul Newman, *The SEC's Influence on Accounting Standards: The Power of the Veto*, 19 J. ACCT. RES. 134, 143 (1981) (asserting that FASB voting rule changes increase the relative power of the SEC); Joshua Ronen, *Discussion of the SEC's Influence on Accounting Standards: The Power of the Veto*, 19 J. ACCT. RES. 157, 158 (1981) (rejecting Newman's conclusions).

³¹⁹ *See* VAN RIPER, *supra* note 16, at 137; Beresford, *supra* note 11, at 60.

³²⁰ *See* VAN RIPER, *supra* note 16, at 110; Beresford, *supra* note 11, at 60.

³²¹ *See* VAN RIPER, *supra* note 16, at 110; Beresford, *supra* note 11, at 60.

erally, collapses into a third complaint: excessive use of rules.³²² Today, all sides call for "principles-based" standards.³²³

Rules-based standards seek to supply a clear answer to every possible situation, pursuing the objective with detailed statements, bright-line tests, and multiple exceptions.³²⁴ Internal inconsistency often results.³²⁵ Comparability also suffers: reporting entities hewing to the same strict standard appear comparable on the basis of their financials when their arrangements in fact are dissimilar.³²⁶ Worse, say GAAP's critics, the rules lead to transaction structuring and other strategic behavior that undermines the quality of financial reporting.³²⁷ Financials that are manipulated in this way, although rule compliant, do not truly and fairly state the reporting company's income and financial position.³²⁸

The latter complaint rang loudly in the wake of the Enron scandal. According to critics, rules-based treatments had been manipulated by users and auditors and had resulted in reporting misstatements.³²⁹ The rules had fostered a dysfunctional, check-the-box approach to compliance.³³⁰ Preparers and auditors applied the rules mechanically and ignored the substance of the transactions being reported.³³¹ The system had fostered a culture of noncompliance in which regulated actors invested in schemes of rule evasion.³³² A principles-based system, critics contended, would be less manipulable and thus superior.³³³ Congress concurred in passing SOX, which instructed the SEC to study the accounting system to ascertain the extent to which it is principles-based and to report on the length of time

³²² See OFFICE OF THE CHIEF ACCOUNTANT, SEC, 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 § I.A (2003) [hereinafter SEC REPORT], available at <http://www.sec.gov/news/studies/principlesbasedstand.htm>; Beresford, *supra* note 11, at 60.

³²³ See VAN RIPER, *supra* note 16, at 192; Schipper, *supra* note 33, at 61.

³²⁴ SEC REPORT, *supra* note 322, § I.C.

³²⁵ *Id.*

³²⁶ *Id.*

³²⁷ Schipper, *supra* note 33, at 68.

³²⁸ See SEC REPORT, *supra* note 322, § I.C; Schipper, *supra* note 33, at 68.

³²⁹ See Steve Liesman, *SEC Accounting Cop's Warning: Playing by Rules May Not Ward Off Fraud Issues*, WALL ST. J., Feb. 12, 2002, at C1.

³³⁰ See *id.*

³³¹ See, e.g., *The Lessons from Enron*, *supra* note 39, at 9–10; Liesman, *supra* note 329.

³³² See *The Lessons from Enron*, *supra* note 39, at 9–10; Liesman, *supra* note 329.

³³³ See *The Lessons from Enron*, *supra* note 39, at 10.

needed to transition to a basis in principles.³³⁴ The resulting SEC Study confirms the relative superiority of principles-based over rules-based accounting and, following the historical pattern, hands the job of reconstructing GAAP back to the FASB.³³⁵

This Part enters a dissenting opinion. GAAP has indeed become increasingly rules-based over time.³³⁶ This is not because general principles no longer influence particular standards—the Conceptual Framework sets out general principles from which GAAP continues to follow loosely—but because the FASB’s constituents register demands for tailored treatments and the FASB often responds favorably.³³⁷ The pattern suggests capture, but also can be described as pluralist responsiveness. Either way, the substantive case against rules-based GAAP is not compelling.³³⁸ The FASB employs rules, despite their shortcomings, because they constrain preparer discretion, facilitate audits, and decrease the likelihood of scandals.³³⁹ These justifications still carry persuasive weight.

A. *Advantages and Disadvantages, Costs and Benefits*

This Section explores in the abstract whether GAAP should be articulated in rules or principles. To avoid the difficult problem of clearly defining the difference between the two, it first describes the dynamic that brings rules into existence.³⁴⁰

Assume that the standard setter has proposed a new principles-based standard. The preparers then use the notice and comment process to seek particular exceptions from the general principles. One means to this end is a “scope exception”: a rule that excludes stated transactions or items from a more general treatment category.³⁴¹ GAAP’s complex derivative rules provide a good example, with nine

³³⁴ See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 108(d), 116 Stat. 745, 768–69 (codified at 15 U.S.C. § 77s (Supp. III 2003)).

³³⁵ See SEC REPORT, *supra* note 322, § VI.

³³⁶ See Schipper, *supra* note 33, at 63.

³³⁷ See *id.* at 63, 66–67.

³³⁸ See *infra* notes 371–442 and accompanying text.

³³⁹ See *infra* notes 349–360 and accompanying text.

³⁴⁰ The meaning of generally phrased principles to some extent lies in the eye of the beholder. See Mark Kohlbeck & Terry Warfield, The Effects of Principles-Based Accounting Standards on Accounting Quality 2 (Mar. 2005) (unpublished manuscript, available at <http://ssrn.com/abstract=724237>) (defining principles-based accounting as emphasizing asset and liability measurement, in particular fair value measurement, as opposed to earnings-based accounting).

³⁴¹ Schipper, *supra* note 33, at 66–67.

exceptions to the definition of derivative, several of which came into the rules solely for the purpose of reducing preparation costs.³⁴² Alternatively, preparers seek "treatment exceptions": special rules for defined items or industry practices.³⁴³ Revenue recognition rules that facilitate income smoothing provide a prominent example.³⁴⁴ Having won their rule-based exceptions, the preparers (and their auditors) then request detailed instructions respecting implementation.³⁴⁵ The FASB responds, and GAAP becomes still more complex.

1. The Case for Rules: Cost Savings, Compliance, and Transparency

Rules-based accounting entails cost savings.³⁴⁶ The cost savings follow from the nature of the subject matter. Accounting standards govern homogenous, recurrent situations where the actors need ex ante instructions and have incentives to invest in compliance.³⁴⁷ Such conditions tend to justify a rules-based approach.³⁴⁸ An across-the-board shift to principles would make sense only if the costs of constantly revising the rules to keep up with unintended applications due to faulty drafting and regulatory arbitrage outweighed the benefits of advance specification.³⁴⁹ GAAP does not appear to lie anywhere near that level of dysfunction. Under this analysis, the indicated course of reform is incremental change. The standard setter monitors the rules' operation, periodically adjusting categories so that reporting results follow from the rules' operative principles.³⁵⁰

Compliance imports a second justification for rules. Detailed rules provide roadmaps both for GAAP compliance and the identification of noncompliance.³⁵¹ The instructions provide a base of common assumptions and knowledge for both preparers and auditors.³⁵² Differences in measurement decrease as a result.³⁵³ Noncompliance becomes

³⁴² *Id.* at 66.

³⁴³ *Id.* at 66–67.

³⁴⁴ *See id.* at 67.

³⁴⁵ *See id.* at 66.

³⁴⁶ Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 972 (1995).

³⁴⁷ *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 570–77 (1992).

³⁴⁸ *See id.* at 577.

³⁴⁹ *See id.*

³⁵⁰ *Cf.* Sunstein, *supra* note 346, at 995 (distinguishing underinclusion from overinclusion).

³⁵¹ *See* Schipper, *supra* note 33, at 68.

³⁵² *Id.*

³⁵³ *Id.*

more evident.³⁵⁴ And, as verification becomes easier, the risk of audit failure decreases.³⁵⁵ Indeed, given a rule, the auditor who discovers noncompliance is more likely to refuse to let the matter pass.³⁵⁶ The rule provides a justification for the refusal, minimizing potential damage to the professional relationship between the auditor and the client. Since the rule makes noncompliance more visible, it also increases the ex post risk of SEC enforcement or civil liability respecting the preparer and the auditor, further strengthening the auditor's resolve.³⁵⁷

Transparency provides a third justification. Detailed rules enhance transparency because their precise instructions narrow the room for differences of judgment.³⁵⁸ To understand this connection more clearly, revisit the legal realists' case for principles over rules with respect to private law adjudication.³⁵⁹ That case presupposes that the law-to-fact application is explained and published in a judicial opinion. The reported cases give the practitioner an expanding body of fact-sensitive applications, ever better articulating the standard's meaning. Over time, the accumulated case law offers the practitioners a level of certainty not dissimilar to that of a rule book, even as the principle's flexibility is retained. Meanwhile, the cases (and thus the substance of the legal regime) are open for public inspection. The ongoing rules-based articulation of GAAP by the FASB works similarly.³⁶⁰ But the application of open-ended accounting principles by preparers and auditors does not. Financial statements and footnotes are very summary documents. Decision making about treatments happens in a black box, evolving as a matter of practice amongst insiders. There is no comparable moment of transparency respecting the law-to-fact application, thereby diminishing the chance for outside evaluation. The law-to-fact applications, meanwhile, are not made by judges empowered by the state. They come from the preparers—the regulated actors themselves—acting with input from the auditor's

³⁵⁴ *Id.*

³⁵⁵ *See id.*

³⁵⁶ *See* Schipper, *supra* note 33, at 68.

³⁵⁷ *See id.* at 68–69.

³⁵⁸ *See id.* at 67–68.

³⁵⁹ *See* William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 746 (2001).

³⁶⁰ According to the FASB, any bias toward rules in contemporary GAAP stems from exactly this sort of law-to-fact development process, as rules are rewritten to take into account different transactional facts and interpretive opinions accumulate. FIN. ACCOUNTING STANDARDS BD., PROPOSAL: PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING 3–4 (2002) [hereinafter FASB, PRINCIPLES APPROACH], available at http://www.fasb.org/proposals/principles-based_approach.pdf.

professional review. And, when it comes to saying no, a professional, even one historically conceived to be in an adversary posture to its client, is in a materially different position from a judge.

2. The Case for Principles: Flexibility and Professional Judgment

The case for principles arises in large measure from the description of the perverse effects of rules. The critics admit the force of the case for rules but assert that once rules come to dominate the accounting regime, cumulative perverse effects cause disadvantages to outweigh advantages.³⁶¹ The more detailed the set of exceptions, the greater the chance that essentially similar transactions receive different accounting treatments.³⁶² Scope and treatment exceptions build inconsistencies into the standards, sacrificing the integrity of the underlying principles.³⁶³ Strategic behavior results as preparers seek to exploit the inconsistencies, designing compliant transactions that subvert the principles the rules supposedly effectuate.³⁶⁴ Meanwhile, proliferating exceptions fuel additional demand for explication from the standard setter.³⁶⁵ The responsive standard setter finds itself attempting to articulate a treatment for every conceivable scenario.³⁶⁶ But the attempt always fails, for the goal of a perfect, exhaustive rule book is unattainable.³⁶⁷

At this point, the case for principles reverses the case for rules. Since the standard setter cannot identify all pertinent business situations *ex ante*, it is not clear why exhaustive instructions should be held out as a goal in the first place, given that micro-level standard setting always results in inconsistencies.³⁶⁸ The only party with all information concerning a given transaction is the reporting company itself. It follows that its internal preparers, operating in good faith, are more likely to derive an appropriate treatment when applying a principle than is a rulemaking standard setter acting *ex ante*. With principles, company-specific knowledge and the regulatory framework in-

³⁶¹ See SEC REPORT, *supra* note 322, § I.C.; Sunstein, *supra* note 346, at 969–96.

³⁶² SEC REPORT, *supra* note 322, § I.C.

³⁶³ See Schipper, *supra* note 33, at 66–67.

³⁶⁴ See SEC REPORT, *supra* note 322, § I.C.

³⁶⁵ See *id.*; Schipper, *supra* note 33, at 67.

³⁶⁶ SEC REPORT, *supra* note 322, § I.C.

³⁶⁷ *Id.*

³⁶⁸ See *id.*

teract flexibly, and the regulation's purpose is more likely to be effectuated.³⁶⁹

3. Summary

These back-and-forth arguments hold out costs and benefits on both sides. Rules narrow discretion and prevent the appearance of first-best financial reports. Principles widen discretion, creating a danger of corruption.³⁷⁰ The answer to the question whether GAAP should be articulated in rules or principles thus depends on the inquirer's further assumptions. If we hypothesize that preparers care only about fidelity to accounting principles, and that audits proceed in an ideal professional environment in which the auditor works unconstrained by pressures of time, price, and reputation, then the case for a principles-based regime is strong. But a plausible case for rules can be stated even under such conditions. This case strengthens materially if we assume that concerns about the bottom line shape preparer incentives along with an imperfect professional relationship between the auditor and the preparer client, an assumption widely held in the present environment.

B. *The Demand for Rules*

Agents of the FASB vigorously defend rules-based GAAP.³⁷¹ Donald Kirk, a founding member and one-time chair, once said that fair presentation does not in the end mean fairness because preparers always compete to find advantageous ways to apply principles-based standards.³⁷² The FASB's agents also repeatedly cite constituent demand.³⁷³ In the FASB's view of the world, the same actor who argues for principles one day turns around the next to demand detailed "guidance" on a particular standard.³⁷⁴ And even as the FASB publicly embraces principles in the wake of demands registered after the Enron scandal, it simultaneously cautions that it does not entirely control the shape its standards take.³⁷⁵ Rather, the standards are informed by reading comment letters, meeting with preparer represen-

³⁶⁹ *Id.* § I.D.

³⁷⁰ See AYRES & BRAITHEWAITE, *supra* note 4, at 56.

³⁷¹ See VAN RIPER, *supra* note 16, at 81.

³⁷² *Id.* at 81–82.

³⁷³ See *id.* at 105.

³⁷⁴ *Id.*

³⁷⁵ See Smith, *supra* note 182, at 3–4.

tatives, and talking with auditors.³⁷⁶ The FASB thus sees itself as a responsive regulator as it tends towards rules.

1. Auditors, Clients, and Plaintiffs

We have seen that preparers petition the FASB for scope and treatment exceptions.³⁷⁷ But the rules mostly proliferate due to the petitions of auditors, which pull the standard setter into multitudinous small issues.³⁷⁸ Client relations motivate this in part. Auditors dislike saying no because audit clients resist naysaying. Absent a precise written justification, they balk at auditor objections to their treatments: "Show me where it says I can't do this."³⁷⁹ The auditor therefore seeks the backing of a precise negative instruction in GAAP before objecting.³⁸⁰ The rule insulates the auditor's professional judgment from the client's negative response and fixes blame on the external authority. Given a rule, the auditor also can assure the client that competing firms will not sign off on its financials either.³⁸¹

The audit profession's fear of enforcement entanglement, in particular civil liability, strengthens the preference.³⁸² With an open-ended principle, both the preparer and the auditor must make a judgment respecting a law-to-fact application.³⁸³ Risk-averse actors in this posture will be wary of second-guessing by regulatory authorities and plaintiff's lawyers.³⁸⁴ The good faith with which they apply the principle will be unverifiable *ex post*. Principles, then, make it hard to minimize enforcement risk.

³⁷⁶ *Id.* at 3.

³⁷⁷ See Schipper, *supra* note 33, at 67.

³⁷⁸ See Beresford, *supra* note 11, at 60.

³⁷⁹ SEC REPORT, *supra* note 322, § III.I.i.

³⁸⁰ See *id.*

³⁸¹ See George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 EMORY L.J. 1325, 1335 (2003).

³⁸² See *id.* at 1331; Hussein & Katz, *supra* note 17, at 74; Mundstock, *supra* note 29, at 839. Note that the auditors' position changed over time: prior to the early 1970s, the primary conflicts that impacted accounting standards were between the preparers and the users, with the auditors acting as neutral go-betweens. Hussein & Katz, *supra* note 17, at 74. The mediative role ceased in the early 1970s due to growing worries about civil liability. *Id.* Thereafter the auditors participated based on their own self-interest. *Id.*

³⁸³ See SEC REPORT, *supra* note 322, § I.C.

³⁸⁴ See *id.*

2. Secondary Capture

Rules often are said to evidence auditor rent seeking. If this is true, then what the FASB describes as responsiveness to constituent demands can be described as a species of capture.

The auditor rent extraction point follows from a public choice description of perverse effects resulting from the enactment of the federal securities laws. Before 1933, nothing required publicly traded firms to undergo independent audits.³⁸⁵ Nor were there any formally designated, generally accepted accounting principles, much less a standard setter.³⁸⁶ The federal securities laws broke the pattern by requiring an independent audit for registered companies.³⁸⁷ This made the large audit firms providers of a necessary professional service and positioned them to collect rents.³⁸⁸ Complex, rules-based standards aid and abet the rent seeking. Complexity by itself generates work.³⁸⁹ It also strengthens entry barriers: over time, fewer and fewer audit firms possess the technical resources necessary for engagements with large clients.³⁹⁰ Indeed, the number of such firms has fallen to four.³⁹¹ Innovation, moreover, is choked off to the extent that it decreases auditability and exposes the firms to legal risk.³⁹²

The account is persuasive as a structural matter: the auditors have gatekeeping power and are not incented to demand first-best GAAP. But there are some qualifications. Audit firms engage in price competition despite their diminishing numbers.³⁹³ The price of audit services fell in the 1980s in the wake of the federal push for increased competition in service provision by professionals.³⁹⁴ Audit quality fell

³⁸⁵ See VAN RIPER, *supra* note 16, at 6.

³⁸⁶ See *id.* at 5.

³⁸⁷ *Id.* at 6.

³⁸⁸ See Benston, *supra* note 381, at 1329–31.

³⁸⁹ See Charles R. Plott & Shyam Sunder, *A Synthesis*, 19 J. ACCT. RES. 227, 231 (1981); see also Mundstock, *supra* note 29, at 817 (charging that the FASB's standards justify high fees in exchange for little work and low legal risk and that its innovations never impair the rent flow to auditors).

³⁹⁰ See Dale Buckmaster et al., *Measuring Lobbying Influence Using the Financial Accounting Standards Board Public Record*, 20 J. ECON. & SOC. MEASUREMENT 331, 340 (1994).

³⁹¹ Shyam Sunder, *Rethinking the Structure of Accounting and Auditing* 18 (Yale Int'l Ctr. for Fin., Working Paper No. 03–17, 2003), available at http://ssrn.com/abstract_id=413581.

³⁹² See Mundstock, *supra* note 29, at 831. Advocates of expanded fair value accounting are particularly likely to make this claim.

³⁹³ See Sunder, *supra* note 391, at 18–20.

³⁹⁴ See *id.* at 20.

with it.³⁹⁵ To see why, hypothesize the incentives of an audit partner under pricing pressure. The audit process begins with an appraisal of the client's risk of compliance failure.³⁹⁶ The auditor's professional judgment concerning the scope of the testing conducted during the course of the audit follows from this risk appraisal.³⁹⁷ The scope of the testing in turn affects the audit fee—as the risk increases, more tests are needed, more time must be spent, and the fee rises. In this scenario, “check-the-box” rules recommend themselves over principles in a hard cash sense because they make companies easier to audit. They enhance verifiability, causing differences in measurement to decrease and making noncompliance more evident.³⁹⁸ The audit becomes faster and more predictable, making it easier to state a price in advance and lock in a profit on the engagement. Contrast this rules-based approach with a regime of principles requiring the preparer to make fact-sensitive applications of the standards. This necessitates a more labor-intensive audit in which unexpected and time-consuming problems are more likely to arise. In sum, price competition for professional services fuels the demand for rules.

At least one empirical study has examined the effects of audit firm lobbying on the FASB's decision-making process.³⁹⁹ The study found that audit firms indeed comment on proposed rules from their own perspectives rather than those of their clients.⁴⁰⁰ Moreover, the FASB is more likely to change a rule in response to auditor, rather than preparer, protest.⁴⁰¹ This result disappears, however, when alternative methodologies are used.⁴⁰² Nor does a statistical finding of responsiveness necessarily imply influence. The record may merely reflect the fact that preparers and auditors tend to comment on different aspects of the same standards.⁴⁰³ The preparers are more likely to object to a standard's very existence or general purposes, matters high on the FASB's substantive agenda; auditors comment on matters

³⁹⁵ Shyam Sunder, *Minding Our Manners: Accounting as Social Norms* 5 (Yale Int'l Ctr. for Fin., Working Paper No. 05-18, 2005), available at <http://ssrn.com/abstract=733743>.

³⁹⁶ HERWITZ & BARRETT, *supra* note 25, at 202–03.

³⁹⁷ *Id.* at 204.

³⁹⁸ See Schipper, *supra* note 33, at 68.

³⁹⁹ See John R. Haring, Jr., *Accounting Rules and “The Accounting Establishment,”* 52 J. Bus. 507, 515 (1979) (concluding that the FASB is not responsive to business interests).

⁴⁰⁰ *Id.* at 511, 515.

⁴⁰¹ *Id.* at 512, 515.

⁴⁰² Buckmaster et al., *supra* note 390, at 341–42.

⁴⁰³ See *id.* at 340.

of technical implementation that are less likely to implicate strong preferences among the members.⁴⁰⁴

3. Summary

Intense demand for rules can be expected to persist and rent seeking by the audit profession figures into the demand. That said, auditor rents do not necessarily figure into the FASB's pattern of positive response. Rules can be justified independently on a principled basis.

C. Rules and Scandals

The oft-voiced claim that rules-based GAAP caused recent accounting scandals is largely unfounded.⁴⁰⁵ This is not because GAAP contains no manipulable rules; it does. Nor is this because the rules have not been manipulated; they have been. Rather, it is because recent corporate scandals and high-profile reporting failures for the most part did not stem from rule manipulation.

Those who denounce GAAP for excessive reliance on rules cite a number of subject matters. These core, rules-based regimes include accounting for derivatives and hedging activity, leasing, real estate sales, stock-based compensation arrangements, consolidation (or other recognition) of related entity financial assets and liabilities, and, prior to reforms instituted in 2002,⁴⁰⁶ mergers and acquisitions.⁴⁰⁷ The General Accounting Office's (the "GAO's") study of public company accounting restatements permits us to gauge the extent to which these rules-based subjects figure into the spate of audit failures, accounting restatements being the results of audit failures.⁴⁰⁸ The study shows that the annual number of restatements rose from 92 in 1997 to 225 in 2001.⁴⁰⁹ From January 1997 to June 2002, the total number of

⁴⁰⁴ *Id.* at 340–42.

⁴⁰⁵ See Benston, *supra* note 381, at 1344–45 (blaming the Enron scandal in part on the fact that GAAP has become increasingly rules-based).

⁴⁰⁶ See generally BUS. COMBINATIONS, Statement of Fin. Accounting Standards No. 141 (Fin. Accounting Standards Bd. 2001), available at <http://www.fasb.org/pdf/fas141.pdf> (ending pooling treatment for mergers).

⁴⁰⁷ SEC REPORT, *supra* note 322, §§ I.G, II.B.

⁴⁰⁸ See generally U.S. GEN. ACCOUNTING OFFICE, GAO-03-138, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES (2002) [hereinafter GAO REPORT], available at <http://www.gao.gov/new.items/d03138.pdf>.

⁴⁰⁹ *Id.* at 14.

restatements announced was 919.⁴¹⁰ These involved 845 companies, amounting to 10% of all of those listed on public exchanges in the United States.⁴¹¹ Issues involving revenue recognition, whether in respect of misreported or nonreported revenue, made up the largest group by subject matter category, accounting for almost 38% of the 919 restatements.⁴¹² The second largest group concerned cost- or expense-related issues, accounting for almost 16%.⁴¹³ The GAAP revenue and cost recognition standards bearing on this 54% majority group are for the most part principles-based—they are phrased in general terms and require significant exercises of judgment in their application.⁴¹⁴

The remaining restatements cover a range of subject matter, some of it rules-based, but most of it principles-based. On the rules-based side are restatements concerning merger and acquisition accounting and derivatives.⁴¹⁵ Skewing toward the principles-based side we find restatements involving in-process research and development, related party transactions, loan-loss reserves and loan write-offs, asset impairment, inventory valuation, and restructuring activity.⁴¹⁶

There is a simple reason why rules-based subject matters do not dominate the list: rule compliance is more easily verified than principle compliance.⁴¹⁷ As we have seen, detailed rules hold out roadmaps both to GAAP compliance and to the identification of GAAP non-compliance.⁴¹⁸ Observers who disapprove of the rules-based treat-

⁴¹⁰ *Id.*

⁴¹¹ *Id.* at 16 tbl.1.

⁴¹² *Id.* at 19.

⁴¹³ GAO REPORT, *supra* note 408, at 20. This group consists of instances of improper cost recognition, tax issues, and other cost-related improprieties that led to financial misstatements. *Id.*

⁴¹⁴ See HERWITZ & BARRETT, *supra* note 25, at 449–53. WorldCom is the most famous recent case of the revenue and cost recognition principles' opportunistic misuse. For description of this fraud, see Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 934–36 (2003).

⁴¹⁵ See GAO REPORT, *supra* note 408, at 21 fig.3, 22 tbl.2. Derivatives are a growth item on the list of restatements. See *id.* at 23. Along with other securities-related restatements, they increased from 4.6% of restatements in 2001 to 12.4% of restatements in the first half of 2002. *Id.* But the category is capacious, and includes errors and misstatements involving derivatives, warrants, stock options, and other convertible securities. *Id.* Some of the standards in question are rules-based, while others are standards-based. Significantly, most involve fair value accounting.

⁴¹⁶ *Id.* at 21 fig.3, 22 tbl.2.

⁴¹⁷ See *supra* notes 351–357 and accompanying text.

⁴¹⁸ See *supra* notes 351–357 and accompanying text.

ments⁴¹⁹ dislike the reporting destinations to which the roadmaps lead. Since these destinations tend to be favored by the preparers, their managers happily comply with the rules. At the same time, a noncomplying preparer is more likely to confront an uncooperative auditor.

There can be no denying that preparers often take advantage of GAAP's rule structures when they design aggressive treatments. Regulatory arbitrage (the practice of structuring an inappropriate transaction so it stays just within the bounds set by a rule) clearly is widespread. But these aggressive rule manipulations, which tend to involve structured finance, leases, and (until recently) pooled mergers, do not show up in large numbers on the list of recent restatements.

The audit failures and restatements follow less from regulatory arbitrage than from strategic noncompliance—action taken based on an interpretation of the law in conflict with the stated interpretation of the regulator.⁴²⁰ Neither rules nor standards prevent such conduct, and, as between the two, rules have the advantage in deterring it.⁴²¹ Meanwhile, in every restatement case, GAAP by definition has proved adequate to the job of identifying the misstatement and providing corrective instructions. Under this analysis, the drafters of SOX were right in thinking that the absence of principles has contributed to the crisis, but wrong in ascribing the problem to the standard setter. This is not for the most part a problem concerning the relative merits of rules and principles in standard setting; it is a problem of compliance and professional practice in a regulatory system made up of both.

⁴¹⁹ See Mark W. Nelson et al., Where Do Companies Attempt Earnings Management, and When Do Auditors Prevent It? 2 (Oct. 22, 2000) (working paper, available at <http://ssrn.com/abstract=248129>) (showing that auditors pass on these treatments as GAAP-compliant).

⁴²⁰ This was certainly the case with Enron. See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1305–09, 1314–1320 (2002). It is true that misleading accounting treatments of transactions between Enron and off-balance-sheet entities lie at the scandal's core, and that the applicable accounting standards are rules-based. See *id.* at 1305–09. Indeed, the form-over-substance treatments of these rules are as notoriously arbitrary as any in GAAP. But, contrary to the conventional wisdom, the central problem at Enron lay not with the rules themselves, but with the company's failure to follow them. See *id.* at 1342. The Enron disaster stemmed not from the rules' structural shortcomings, but from the corruption of Enron's managers and perverse financial incentives that inclined its auditor towards cooperation. *Id.* at 1305–09, 1314–20.

⁴²¹ See *supra* notes 351–357 and accompanying text.

D. *The SEC Intervention*

There is, then, no foundation for the proponents' belief that principles by themselves solve compliance problems. The recent history of audit failure has been no respecter of principles. The case for principles accordingly returns us to the auditor-client relationship to inquire into preparers' incentives and the quality of auditors' professional judgments. If recent history is predictive, the prognosis is not good. The preparers have been guided by short-term solicitude for their own stock prices rather than by fidelity to accounting principles, and the auditors have been disinclined to stop them. It will take more than a new approach to standard setting to bring incentive compatibility to this context.

The SEC attempts to negotiate this problem in its report under SOX by taking a split-the-difference approach that it calls "objectives-oriented."⁴²² As an exemplar, it offers the FASB's recent revision of the standard for mergers.⁴²³ Here is the SEC's description of a principles-based system:

[T]he optimal principles-based accounting standard involves a concise statement of substantive accounting principle where the accounting objective has been incorporated as an integral part of the standard and where few, if any, exceptions or internal inconsistencies are included in the standard. Further, such a standard should provide an appropriate amount of implementation guidance given the nature of the class of transactions or events and should be devoid of bright-line tests. Finally, such a standard should be consistent with, and derive from, a coherent conceptual framework of financial reporting.⁴²⁴

This takes a step back from the base case for principles. The principles-based approach relies on the preparer to make a good faith application of the open standard to particular facts and assumes that a successful system depends on exercises of professional judgment by

⁴²² SEC REPORT, *supra* note 322, § I.C. For additional comments on the SEC intervention, see Lawrence A. Cunningham, *Interpreting the Rhetoric of "Principles-Based" Systems in Corporate Law, Securities Regulation and Accounting* (2006) (unpublished manuscript, on file with author). In Cunningham's view, the SEC's "objectives-oriented" standards are nothing more than GAAP's prevailing mix of rules and standards. *Id.* (manuscript at 52-57).

⁴²³ SEC REPORT, *supra* note 322, §§ I.C, I.E.

⁴²⁴ *Id.* § I.C.

auditors and preparers who are motivated by fidelity to the goal of fair representation.⁴²⁵ The SEC removes this stress on the regulated actors' responsibility for law-to-fact determinations by endorsing the legitimacy of constituent demands for specificity.⁴²⁶ It then shifts a burden of specificity back to the standard setter to provide "an appropriate amount of implementation guidance."⁴²⁷ Bald statements of principles, says the SEC, provide preparers and auditors insufficient structure in which to frame their professional judgment.⁴²⁸ The "principles" need to be "defined specifically."⁴²⁹

The SEC does not entirely abandon the objectives of principles-based standards, however.⁴³⁰ Its projected regime appears to hold out the benefit of a decrease in the level of reporting detail.⁴³¹ At the same time, comparability of treatment across different issuers would be enhanced through the avoidance of scope and treatment exceptions.⁴³² But the decrease in complexity implies a concomitant loss of transparency, since commonality of treatment obscures particulars in the economics of differing underlying transactions.⁴³³ Relevance, reliability, and comparability become matters to be traded off by the standard setter in a balancing exercise.⁴³⁴ At the bottom line, says the SEC, economic substance should drive the development and scope of the standards.⁴³⁵

Although this sounds plausible, a question must be asked: How does the regime envisaged simultaneously articulate precise instructions and eschew all exceptions from its categories? So doing would amount to a considerable achievement. The drawing of lines is intrinsic to regulation. Line drawing is what case law under principles is supposed to do. It is not at all clear that financial reporting standards

⁴²⁵ See Schipper, *supra* note 33, at 61; see also *Accounting Reform and Investor Protection: Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 107th Cong. 148-49 (2002) (prepared statement of Sir David Tweedie, Chairman, International Accounting Standards Board) (describing the European system); Mundstock, *supra* note 29, at 844 (suggesting that principles-based standards will be favored by preparers).

⁴²⁶ See SEC REPORT, *supra* note 322, § I.C.

⁴²⁷ *Id.*

⁴²⁸ *Id.*

⁴²⁹ *Id.*

⁴³⁰ See *id.* § IV.D.

⁴³¹ See SEC REPORT, *supra* note 322, § IV.D.

⁴³² See *id.* §§ I.C, IV.D.

⁴³³ The comments in the text draw on FASB, PRINCIPLES APPROACH, *supra* note 360, at 7.

⁴³⁴ See SEC REPORT, *supra* note 322, § III.C.

⁴³⁵ *Id.*

differ from any other body of regulation in this regard. So, to the extent that the SEC looks toward a new regime in which all standards mesh like the parts of a well-running machine, it is likely to be disappointed. Such perfect engineering is no more likely here than in any other regulatory context.⁴³⁶

The SEC, in its search for a regime of broadly stated standards that incorporate no exceptions, might be better off abandoning the rubric of principles-based accounting. The system envisioned more accurately would be characterized as one of tough, general rules.⁴³⁷ Such a regime would have advantages. For example, it presumably would prohibit whole classes of aggressive treatments tolerated in recent years, particularly those facilitating income smoothing. But if this is what the SEC has in mind, another question arises: In the present political and institutional context, how likely is it that the preparers, their auditors, and their friends in Washington would permit the FASB to use the rubric of principles-based accounting to usher in a new era of strict treatments? Looking at the four-decade history surveyed above, the answer must be: very unlikely.

As a practical matter, then, if the SEC is serious about this move to principles, then preparer and auditor judgments will matter more in the future. The SEC acknowledges this when it warns that principles-based accounting implicates a more expensive, time-consuming audit process.⁴³⁸ It anticipates that, in order to review preparer judgments, audit firms will have to hire expensive personnel with expertise in complex transactions.⁴³⁹ It also anticipates that the system will require active audit committee oversight and other strong enforcement agents.⁴⁴⁰ Finally, it advises auditors and preparers to generate extensive paper records respecting treatment decisions, so as to position themselves to defend their good faith.⁴⁴¹ We get principles, then, but no reliance on those applying them.

At the bottom line, the SEC is asking the users to trust that the creation of the new Public Company Accounting Oversight Board

⁴³⁶ See FASB, *PRINCIPLES APPROACH*, *supra* note 360, at 6.

⁴³⁷ The FASB's 2002 proposal in effect warns audit firms and issuers of this when it points out that principles will mean more volatility in reported earnings figures. See *id.* at 7-8.

⁴³⁸ See SEC REPORT, *supra* note 322, §§ I.C, I.I, V.H.

⁴³⁹ See *id.* § I.I.

⁴⁴⁰ *Id.* § III.J.

⁴⁴¹ *Id.*

(the "PCAOB")⁴⁴² effects a shift to a robust compliance regime. The question is whether this better, more principles-based world can be realized without unintended negative effects due to poor professional judgment.

E. Summary

The public-private distinction helps to explain the connection between the standards' form and the audit process. The FASB, by conjoining agency independence and substantive alignment with the user interest, traverses the interests of a key constituent: corporate management. This has a negative consequence. For the self-regulatory reporting system to work well, management must internalize the spirit of the standards and cooperate fully with the audit firms. It has done neither, and the standards' form has been skewed as a result. No one, however, suggests the corrective of reconstituting the standard setter along pluralist lines. We have instead chosen to regulate the auditors. The PCAOB has the job of ameliorating the cooperation problem by forcing the audit firms to reject aggressive preparer treatments. If the PCAOB succeeds at this, then, and only then, will the FASB be free to move toward principles.

CONCLUSION

The FASB's variant on the New Deal agency model remains robust. Privately constituted, but now publicly funded, the FASB is more independent than ever. It may be second best, but nobody seems able to suggest something better. Public interest advocates would remove financial standard setting to a government agency. That would succeed in getting a new hearing for substantive views that have not found favor at the FASB. But it is by no means clear that better standards would result. Public choice theorists propose the more radical alternative of deregulating GAAP by leaving the development of standards to preparers and auditors operating in spontaneous order. But turning back the clock to 1929 presents significant risks and therefore has little practical appeal.

⁴⁴² Sarbanes-Oxley Act of 2002 § 103(c), 15 U.S.C. § 7213(c) (Supp. III 2003). Under SOX, the PCAOB is not a U.S. government agency, but a private organization with a governmental mandate. *Id.* § 101(b). For the view that the PCAOB should be considered a U.S. government agency for due process purposes, see generally Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975 (2005).

