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Has the FASB Outlived Its Usefulness?

By Alex J. Pollock

Breaking accounting rules has given rise to remarkable scandals and the end of many previously stellar careers. U.S. accounting standards are set by the Financial Accounting Standards Board (FASB) in a process which is not only technical, but also political. Many important accounting ideas are highly debatable, inherently imprecise, and require significant subjective judgment. Faced with this reality, the FASB has in more than thirty years of existence produced a great elaboration of long, complex, and detailed prescriptive accounting rules. Yet accounting scandals are as prevalent as ever. Has the FASB approach worked?

Accounting is probably not at the top of most people's list of scintillating subjects for conversation or thought. Yet it is at the root of many famous scandals that are subjects of extensive news coverage and popular gossip. These scandals involve billions of dollars, huge lawsuits, the destruction of previously stellar careers (not to mention time in prison), and political and regulatory overreactions which generate huge compliance costs.

Typical discussions and journalistic accounts of these scandals imply that accounting has obviously right answers, that accounting—with its "bottom line" and balance sheet—is an objective depiction of business activities, and that accounting can be "transparent" and true in some simple sense. None of this is believed by a single financial professional.

"Inherently Abstract and Debatable Concepts"

Upon examination, the uncertainties of accounting become philosophically interesting, at least for those with a taste for wondering about the relationship between abstractions and reality. The Institute of Chartered Accountants in England and Wales (ICAEW) has pointedly summarized the situation in which accounting finds itself:

> Financial reporting attempts to measure inherently abstract and debatable concepts such as income and net assets, and it has particular features that make it to some extent inevitably subjective and even arbitrary. It also tries to portray a reality that is constantly changing, partly in response to changes in measurement itself. Financial reporting measurement is therefore a matter of evolving conventions, not something to which there are immutably right and wrong answers.[1]

This is insightful. Particularly interesting, if pessimistic, is the recursive issue: accounting rule changes may induce changes in economic and financial behavior, which in turn render the rules inadequate. Think of it metaphorically as an application of Heisenberg's uncertainty principle applied to accounting: deciding how to count the beans may further change the way the beans have to be counted—a sophisticated thought.

A few things about accounting are genuinely clear, such as—for example—the amount of cash on the statement date and the requirement that debits must equal credits. But as the ICAEW suggests, upon close inspection, many accounting concepts are fuzzy, obscure, and subjective. Accounting debates are often hard to follow, resembling metaphysical disputes in an odd dialect of English ("an assumption of no ineffectiveness" is one of my

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favorite phrases), and are carried out with a surprising level of emotion.

The uninitiated might be forgiven for expecting that discussions of accounting concepts would be calm and dispassionate. As a British accounting-issues committee observed in the 1970s: "We have been surprised at the vehemence of the debate and the extent to which entrenched positions have been taken up in support of one concept or another."[2]

This vehemence may arise because schools of accounting resemble to some extent political factions or religious sects. It also reflects the fact that financial statements, once produced, take on a reality of their own, with real-world economic and financial effects—on bonuses, promotions, investments, dividends, and taxes. In one cynical rendition: "The accounting can stay irrational longer than you can stay employed."

With the variety of accounting ideas, it is not surprising to discover variety in accounting practice. It has been argued to me, I believe correctly, that if you took two accounting firms, locked them in two separate rooms, and gave them each the business records of any reasonably complex company and the same set of accounting rules, they would produce two different sets of financial statements. Four accounting firms locked in four separate rooms would produce four different statements.

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Former FASB chairman Dennis R. Beresford, discussing the increasing complexity of accounting standards, cites a KPMG comment on the application of one such rule: "Three knowledgeable informed bodies—the firm, the PCAOB [Public Company Accounting Oversight Board], and the SEC [Securities and Exchange Commission]—had reached three different conclusions on the proper accounting."[3]

Beresford further observes that in trying to interpret accounting rules—an activity inherently requiring judgment calls—companies are now exposed to four different levels of second-guessing: external auditors, the SEC, the PCAOB, and plaintiffs' lawyers. The first of these actually has two separate levels, since the head office bureaucracies of the accounting firms also second-guess the engagement partners, thus making five levels of second-guessers in all.

Yet we observe in many official pronouncements a constant longing for "investor confidence"—in particular "confidence in accounting." This is often phrased as a great need to "restore investor confidence," as if there were a lost Eden or golden age when everyone could believe in financial statements. This is an age which never existed.

A more direct expression of this longing is the desire to "restore investors' *faith* in financial statements."[4] Faith in accounting? I think that everybody involved would be better served by a healthy skepticism than by confidence or faith.

It is no wonder that there is a widespread desire to delegate these frustrating accounting debates to a committee. Could we not have an authoritative, full-time, formal committee of experts to determine the "right" answers and inspire "confidence" or even "faith" in accounting? In the United States, this longing was realized with the creation of the FASB in 1973.

We now have over three decades of experience with this approach. Has it worked?

Sobering Judgments

In November 2006, the chief executives of the six largest accounting firms—PricewaterhouseCoopers, KPMG, Deloitte & Touche, Ernst & Young, BDO, and Grant Thornton—jointly issued a paper entitled *Global Capital Markets and the Global Economy*.[5] It included the following notable judgments:

- "Today's rules can produce financial statements that virtually no one understands."[6]
- "In a world of 'mass customization,' standard financial statements have less and less meaning and relevance."[7]
- "Complex rules must be resisted and withdrawn."[8]

Taken together, these are sobering judgments on the efforts of the FASB, the very font of complexity, whose combined complicated rules run to thousands of pages and continuously expand. Have these efforts—made at great direct expense, and vast administrative expense imposed on companies—achieved their intended purpose?

Consider some history: the late 1960s was "a period of unprecedented stress for the individual members and institutions of the accounting profession . . . [with] a wave of criticism of corporate financial reporting."[9] There were more than fifty lawsuits pending against public accounting firms in 1967, and accountants experienced "a barrage of public criticism."[10]

Then in 1970, the largest bankruptcy up to that point—that of the Penn Central Railroad—"called into question not only the regulators' but also auditors' effectiveness."[11]

In the wake of scandal and criticism, the FASB was formed. But it seems that the more things change—and the more lengthy, complicated, and prescriptive the accounting rules become—the more things stay the same, except for becoming more expensive.

As we enter 2007, the longing to make investors confident in accounting is still unsatisfied. The "vision" of the top accounting-firm chief executives cited above begins in anguish: "Investor confidence is easily shaken, but hard to restore. In the wake of corporate scandals, regulators, issuers, investors and public company auditors have all had important roles in working to win back that trust."[12]

Note the dubious and unargued assumption that the trust was there in the first place, able to be won "back." But there is a more fundamental problem with this statement of the objective.

The problem with investor confidence is not that it is too "easily shaken," but that it is too credulous. No professional investor thinks it is a virtue to be "confident" or to operate on "faith" or "trust." For investing disciplines, the necessary rule is to be extremely skeptical. Ordinary investors should understand the motto of Wall Street, as recently formulated by an experienced banker, Don Shackelford: "From each according to his gullibility, to each according to his grasp."[13]

Worthy of particular skepticism is GAAP accounting, laden with ever more complexity which increases opacity, not transparency. GAAP stands for "generally accepted accounting principles," but they really have nothing to do with general acceptance. They are the rules pronounced by a committee, the FASB, even if such rules are generally opposed by knowledgeable financial professionals.

This was the case for the notorious financial accounting standard (FAS) 133 on accounting for derivatives, which, including its interpretations, totals more than 800 pages. That different accountants, even without being locked in separate rooms, come up with different financial statements under FAS 133—either in spite of or because of its 800 pages—is empirically evident. Of the instructive case of FAS 133, see more below.

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The key point in this context is that FAS 133 is a clear example of the fact that accounting rules are invented, not discovered. They are constructed in a complex process that is often highly political. This is yet another reason why the slogan "restoring investor confidence" needs to be revised to "promoting investor skepticism."

Growing Complexity

The six accounting-firm CEOs are undoubtedly right that "[c]omplex rules must be resisted and withdrawn." But it is exceptionally difficult to take a complicated set of rules and make them simpler, as every effort to "simplify" the Internal Revenue Code has shown. Indeed, all systems of rules tend to grow more complex with time.

In addition to this general tendency, it is easy to see another factor at work in the FASB case. If you set up a full-time organization with an energetic staff and a dedicated board, the sole function of which is to write accounting rules, then its very raison d'être is an ever-increasing body of rules. It cannot do anything but invent rules. So it is hardly surprising that it continuously writes, elaborates, and expands accounting rules.

The obvious alternative is a part-time body of people who have other things to do and other justifications for their professional existence. This was the situation before FASB, but was judged unsatisfactory at the time. Have we really made progress since?

One Right Answer?

Perhaps there is a deeper reason that the approach of a full-time committee of experts has not fulfilled the hopes of the 1970s. Underneath the belief in such a committee is an assumption that does not stand up to scrutiny: the assumption that in accounting there is only one right answer and that therefore all other answers are wrong. The ICAEW's comment continues:

> Financial reporting measurement is therefore a matter of evolving conventions, not something to which there are immutably right and wrong answers. Yet the dominant style of thinking about measurement requirements hitherto has been a deductive one. It tends to assume that there is a theoretically correct answer, and then considers how this can be implemented in practice.[14]

Accounting history makes it obvious that, as the ICAEW argues, accounting rules cannot be deductively derived from axioms like geometrical propositions. They are not matters of scientific empirical demonstration. Thus, accounting rules are "a matter of evolving conventions" or "must rest on a set of conventions"—the latter being the conclusion of the American Institute of Certified Public Accountants in 1972, pre-FASB.[15]

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In other words, accounting rules are not just matters of numbers and techniques; they are necessarily matters of politics, philosophy, and fundamentally imprecise ideas. This explains why all attempts—including the FASB's—to give accounting a universal "conceptual foundation" have failed. Such attempts all break down into competing, mutually inconsistent theories—just like politics or philosophy.

The ICAEW argues that "decisions on the regulation of financial reporting measurement should be regarded as matters of public policy, should be subject to the overriding tests of cost-effectiveness and fitness for purpose."[16] This means that politics and inconsistent theories are inherent to accounting rules, rather than being aberrations which can be eliminated by a committee of experts.

The FASB Monopoly

Americans do not generally like monopolies. Yet we have the FASB, a monopoly in creating accounting rules. The public cannot vote out the FASB if its performance is unsatisfactory. What are the appropriate checks and balances for a committee with compulsory accounting power?

For most of its life, the FASB was funded by contributions from accounting firms and companies. This provided some possibility of checks and balances, since contributions might be reduced or withheld. But the Sarbanes-Oxley Act of 2002 removed private funding and instead imposed a compulsory, statutory assessment of public companies, funding the FASB with what are in effect taxes.

The rationale for imposing these taxes was to make the FASB "independent." But the principle of our constitutional system is that no source of compulsory power should be independent. The search for "independence," like that for "confidence in accounting," appears to reflect the belief that accounting questions have one true answer.

Ultimately, Congress can provide checks on the FASB when petitioned by the people to redress accounting rule grievances. Congress has occasionally specified or blocked accounting-rule proposals when it deemed them for or against public purposes. These interventions are always heavily criticized by those who believe accounting must be left to the "experts." However, the entire legislative structure of accounting in financial markets as created by the various securities acts, including the existence of the SEC, reflects political goals and political decisions.

Congress should retract the Sarbanes-Oxley funding scheme, which has increased the monopoly power of the FASB, and instead try market discipline.

The market answer to monopoly power is competition. Why should the FASB exist as a monopoly? An alternate approach would be competition in the creation of accounting rules.

Competition

In their recent book *Worldwide Financial Reporting*, George Benston, Michael Bromwich, Robert E. Litan, and Alfred Wagenhofer make a good case for such competition. They point to "the lack of empirical evidence to support [the] belief that investors have been better served by financial accounting since standard setting became a government-directed and enforced enterprise."[17]

Moreover, consistent with the discussion above, they argue: "Accounting scandals in the United States have been just as frequent, if not more so, since the SEC was created and standard setting was expanded under the FASB."[18] They propose to replace the FASB monopoly with what they call "constrained competition": "Companies would be allowed to choose among two or possibly more financial accounting standards that are widely recognized," since "the benefits of uniformity are overstated," and "a certain set of accounting standards could perform well for certain industries but badly for other industries," and that "one of the virtues of having different standard setters is that this allows for different approaches to answering these [contentious accounting] questions."[19]

Financial statements are of course an essential input into analysis for decisions of many kinds, including investment decisions—but only one input.

With no single, immutably right answers to be imposed on everybody, multiple perspectives are likely to convey more of reality than a single perspective.

In a similar vein, Shyam Sunder maintains: "Replacing the current monopoly by multiple accounting rule makers who compete for the allegiance and fees from the reporting firms will help develop better rules and lower cost of capital."[20]

Both Benston et al. and Sunder point out an obvious way to begin such competition: let U.S. companies choose between GAAP (as defined by FASB) and the International Financial Reporting Standards defined by the International Accounting Standards Board (IASB), with appropriate disclosure. FASB and IASB would then compete for the preferences of companies, investors, creditors, analysts, and other users of financial statements.

This is a quite conservative step toward a competitive model and should be implemented.

A Delusive Goal

A fundamental cause of accounting debates has been described as changing the purpose of accounting "from a report to absentee owners attesting to managements' (agents) successful stewardship and accountability, to a report to potential investors reflecting the company's potential."[21]

In other words, the idea is that financial statements should tell you about the future, about the market value of the company, and which stocks to buy or sell. In my opinion, this is a foolish notion. It leads the FASB to include "fair market values" or guesses about what market values might be into more and more accounting rules.

In "The Limitations of Financial Reporting," Wolfgang Ballwieser observes that such arguments "overestimate the possibilities of financial reporting" by ignoring the large difference between what financial statements are able to capture and some of the most important factors which create the value of an enterprise.[22]

A good example is accounting for research and development (R&D) efforts which internally produce intangible assets. Under a very old GAAP rule, FAS 2, all the costs of R&D must be expensed. In my opinion, this is a correct accounting rule, since otherwise what would be recorded would be merely guesses about future commercial possibilities. So there is no asset on the books. But it is extremely unlikely that the value of all R&D is zero. Is this difference a problem? Only if you think that the financial statements should tell you the value of the firm. They will not and should not try to.

Financial statements are of course an essential input into analysis for decisions of many kinds, including investment decisions—but they constitute only one input. Their goal should not be to measure the value of the firm, but something more modest and achievable: to make a historical record of transactions and then to present as accurately as possible a summary representation of the financial results of these transactions. As Robert A. Healy, the longest-serving commissioner in the SEC's history, said in the 1930s, the purpose of accounting is "to make a historical record of events," and further that "the purpose of accounting is to account—not to present opinions of value."[23] But even in this modest form, accounting necessarily involves "abstract and debatable concepts,"[24] inherently imprecise ideas, and political compromises.

Discussing contemporary accounting scandals in 1967, *Forbes* advised its readers:

> A company's greatest asset will never appear on any audited statement: the quality of the company's management and the validity of its corporate philosophy. The smart investor will do well to remember that it's the intangibles that really count—and no accounting system can ever measure them.[25]

That analysis was right in 1967, and it is still right in 2007—after three decades of monumental elaboration of accounting rules by the FASB.

Coda: Fannie Mae Meets FAS 133

One of the most notable and controversial FASB productions is the convoluted mass of accounting rules for derivatives known as FAS 133. I have elsewhere enumerated the many conceptual failings and unfortunate consequences of this standard.[26] Most significantly, it causes misleading reported profits by forcing one side of what in economic fact are two-sided financial positions to be marked to market through earnings.

Among the memorable accounting scandals of the new century is that of Fannie Mae, the giant government-sponsored mortgage-financing corporation. Once considered so politically and financially well-wired as to be impregnable, beginning in 2004 Fannie was brought low and made to eat a very great amount of humble pie because of its failure to follow accounting rules. Several accounting standards were involved, but the overwhelming issue was—and is—FAS 133.

Fannie Mae suffered severe regulatory criticism and penalties, the ouster of top management, the departure of various directors, terrible press, and a drop of its stock price of about 50 percent. In December 2006 the regulator announced a suit seeking to recover $215 million from the former CEO and two other senior officers for their alleged roles in the accounting scandal.

It goes without saying that Fannie should have followed the complicated rules of FAS 133, even though the interpretations of these rules were changed by different accountants. Failure to do so has involved the company in a restatement of prior years' financial reports back to 2002. Primarily because of FAS 133, this effort is massive and enormously expensive, costing over $1 billion in 2006 and apparently $1.6 billion overall, with 600 employees and 2,000 hired contractors recounting the beans in extremely complicated ways. How much of this is due to FAS 133 alone is unclear, but a conservative guess would be at least $1 billion.

I am not sympathetic with Fannie Mae in general and have, like others, proposed its privatization.[27] But its sufferings provide an interesting context in which to think about the FASB.

Fannie's $1.6 billion in accounting expenses has produced restated financial reports which are hard to understand. They show that retained earnings, or aggregate profits of all restated results, were reduced by $6.3 billion. This was principally due to reducing the value of derivatives because they were not available for "hedge accounting" under the FASB's rules, although they were economically hedges—in other words, the restatement was due to having only one side of a two-sided transaction affect accounting profits.

Paradoxically, in spite of these accounting losses, stockholders' equity went *up* by $4.1 billion at the same time. This would puzzle old-fashioned accountants. Fannie's explanation is that "Accumulated Other Comprehensive Income" went up by $10.4 billion, which includes increased mark-to-market values of investments in mortgage securities—in other words, the other side of the two-sided transaction. But these value changes are not counted in accounting "profit."

Stock analysts at Morgan Stanley—sophisticated observers—commented, "We have so far found little of interest in the GAAP results."[28] Is that what you get for $1 billion? What are ordinary investors to conclude about this FASB-compliant accounting, other than that they are befuddled by it?

Suppose Fannie Mae investors were offered this choice: you can have financial statements without FAS 133 adjustments and $1 billion in cash, or you can have statements compliant with FAS 133 and be out the cash.

The choice seems easy to me: I would take the $1 billion. This choice would be consistent with the conclusion of Eugene Flegm, a very experienced accounting veteran, who writes: "I submit that FASB has outlived its usefulness."[29]

AEI research assistant Daniel Geary worked with Mr. Pollock to produce this Financial Services Outlook.

Notes

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2. Ibid., 5.
3. Quoted in Eugene H. Flegm, "Accounting at a Crossroad," *The CPA Journal*, December 2005, 6, available at www.nysscpa.org/cpajournal/2005/1205/infocus/p16.htm (accessed January 5, 2007).
4. George Benston, Michael Bromwich, Robert E. Litan, and Alfred Wagenhofer, *Following the Money: The Enron Failure and the State of Corporate Disclosure* (Washington, DC: AEI-Brookings Joint Center for Regulatory Studies, 2003), 80 (emphasis added), available at www.aei-brookings.org/admin/authorpdfs/page.php?id=242.
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6. Ibid., 3.

7. Ibid., 2.

8. Ibid., 3.

9. American Institute of Certified Public Accountants [AICPA], *Establishing Financial Accounting Standards*, Wheat Commission report, March 1972, 3.

10. "What Are Earnings? The Growing Credibility Gap," *Forbes*, May 15, 1967, 5.

11. Anita Dennis, "Taking Account: Key Dates for the Profession," *Journal of Accountancy* (October 2000): 104.

12. Samuel A. DiPiazza et al., *Global Capital Markets and the Global Economy*, 1.

13. Don Shackelford, private memorandum, 2006.

14. ICAEW, *Measurement in Financial Reporting*, 2.

15. AICPA, *Establishing Financial Accounting Standards*, 19.

16. ICAEW, *Measurement in Financial Reporting*, 2.

17. George Benston, Michael Bromwich, Robert E. Litan, and Alfred Wagenhofer, *Worldwide Financial Reporting: The Development and Future of Accounting Standards* (New York: Oxford University Press, 2006), 242.

18. Ibid.

19. Ibid., 237, 242.

20. Shyam Sunder, "Regulatory Competition for Low Cost-of-Capital Accounting Rules," *Journal of Accounting and Public Policy* 21 (2002): 147.

21. Eugene H. Flegm, "Accounting at a Crossroad," 6.

22. Wolfgang Ballwieser, "The Limitations of Financial Reporting," in Christian Leuz, Dieter Pfaff, and Anthony Hopwood, eds., *The Economics and Politics of Accounting: International Perspectives on Research Trends, Policy, and Practice* (New York: Oxford University Press, 2004): 59–62.

23. Quoted in Steven A. Zeff, "The SEC Rules Historical Cost Accounting: 1934 to the 1970s" (conference presentation, Information for Better Markets conference, ICAEW, London, December 18–19, 2006), 2.

24. ICAEW, *Measurement in Financial Reporting*, 2.

25. "What Are Earnings?"

26. See Alex J. Pollock, "FAS 133: What Is Accounting Truth?" *Journal of Applied Corporate Finance* 17, no. 3 (Summer 2005), 102–6, available at www.aei.org/publication23221/; and Alex J. Pollock, "FAS 133 Gets a D–," *National Mortgage News*, February 28, 2005, available at www.aei.org/publication 22034/.

27. Alex J. Pollock, "The Housing GSEs: Through Competition to Privatization," *Financial Services Outlook* (August 2004), available at www.aei.org/publication21042/.

28. Morgan Stanley, "Fannie Mae: Restatement Shows Strong Balance Sheet," December 6, 2006, 1.

29. Eugene H. Flegm, "Accounting at a Crossroad," 8.