

Response to FAF Exposure Draft, “Proposed Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB”

American Accounting Association’s Financial Accounting Standards Committee

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ABSTRACT

The Financial Accounting Standards Committee of the American Accounting Association (the Committee) is charged with responding to requests for comments from standard-setters on issues related to financial reporting. The Financial Accounting Foundation (FAF) released for public comment on December 18, 2007 with a response period ending on February 10, 2008, “Proposed Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB” (the proposal). This commentary concerns four important public policy issues in the proposal with the most relevance for accounting standard setting:

1. Reduce the size of the FASB from seven members to five;
2. Retain the FASB simple majority voting requirement;
3. Realign the FASB composition; and
4. Provide the FASB Chair with decision-making authority to set the FASB technical agenda.

On February 26, 2008, the FAF accepted all four proposals that we commented on. Despite their approval by the FAF, we maintain that each of these proposals not only does not improve, but potentially weakens the standard setting model. We encourage the FAF to renew its commitment to a member selection model designed to create an independent standard setting board. The four proposals put forth by the FAF can only increase the political nature of the FASB, further concentrate decision making power, and create higher barriers to achieve general acceptance of accounting standards. We maintain that the FAF should move in the opposite direction. In particular, we recommend that the FAF not reduce the FASB size and adopt a supermajority requirement not a simple voting requirement. If the majority cannot convince other members of the FASB about their views, how can we expect general acceptance of accounting standards in society? We also want a FASB that is open to more diverse views and more democratic. We urge the FAF to renew its commitment to openness and engagement with the accounting community instead of becoming more elitist and further concentrating power in the hands of a powerful chairman and a smaller standard setting board.

INTRODUCTION

The Financial Accounting Standards Committee of the American Accounting Association (the Committee) is charged with responding to requests for comments from standard-setters on issues related to financial reporting. The committee appreciates the opportunity to respond to the proposal by the Financial Accounting Foundation (FAF) to change the oversight, structure, and operations of the FAF, the Financial Accounting Standards Board (FASB), and the Governmental Accounting Standards Board (GASB). The comments in this response reflect the views of the individuals on the Committee and are not necessarily those of the American Accounting Association.

The FAF Board of Trustees is responsible for the appointment and oversight of members of the FASB and the GASB. The FAF recently released for public comment, “Proposed Changes to Oversight, Structure, Operations of FAF, FASB, and GASB” (The proposal). The proposal contains 11 recommendations, four of which pertain to the FASB. Our commentary concerns these four proposals.

- 1. Reduce the size of the FASB from seven members to five;*
- 2. Retain the FASB simple majority voting requirement;*
- 3. Realign the FASB composition; and*
- 4. Provide the FASB Chair with decision-making authority to set the FASB technical agenda.*

The FAF subsequently adopted each of these proposals. Nevertheless, we continue to view them as potentially detrimental to the standard setting process. In the remainder of this paper, we draw upon research and analysis from various academic literatures to support our positions. First, we do not support the reduction in the size of the FASB. Second, we support a return to the FASB's original supermajority voting requirement predicated on abandoning the current practice of politically dividing the FASB by constituencies. Third, we do not support the FAF's proposal regarding realignment of the FASB composition. Instead, we suggest a model for structuring the Board more consistent with the founding principles of the Board. Fourth, we do not support the FAF's proposal to provide the FASB Chairperson agenda setting authority. Our conclusions derive from an analysis of the FAF's stated reasons for their proposed changes. Finally, we address a widely speculated alternative agenda behind the FAF's proposals that could change the nature of the analysis of the specific proposals if it had been asserted.

Reduce the Size of the FASB from Seven Members to Five

The size of the FASB was originally set at seven based on a recommendation by the Wheat Committee in its 1972 report. The Wheat Committee report explained that the seven person board "seems to be small enough to be efficient and large enough to provide for a variety of views and backgrounds." The Committee added that if experience suggests that a different sized board would be better, "it could be changed under the power of review given to the Board of Trustees of the Foundation." The reasons given by the FAF for reducing the size of the FASB are so that the Board can be more efficient and nimble in decision making and can better coordinate with the IASB. There is also a stated assumption that reducing the size of the Board will not reduce the quality of decision making ("Trustees believe that a five-member FASB

would be more effective and efficient and would operate without any decrease in quality or due process” – page five of the proposal). Interestingly, the FAF did not propose a similar reduction in the size of the GASB.¹

The desire for more efficiency and nimbleness in accounting standard setting seems warranted. A study of standard setting organizations by Jamal and Sunder (2007) finds that the FASB is a slow standard setter relative to other private sector standard setters in the economy. According to Jamal and Sunder (2007), the slowness of the FASB is due to use of a hierarchical and concentrated decision making process with very little input from professional constituencies compared to other professional bodies. Other professional standard setting bodies, especially in engineering and technology, engage more effectively in grassroots participation and bottom-up decision making from their constituencies.² The existence of a large structured finance community that actively seeks to exploit loopholes in accounting standards makes more nimbleness desirable, but the FAF’s proposal to further concentrate decision-making is unlikely to achieve such a goal. On the other hand, a more bottom-up standard setting process (rather than a more concentrated top-down process) is more likely to achieve the speed, nimbleness and general acceptance that the FAF seeks.³

The optimal size of a committee depends on a number of considerations. If the members of the FASB are neutral judges seeking to determine an optimal accounting standard, then the key normative insight in the social choice literature that has been widely accepted since the late

¹ The stated reason for this is that the GASB members other than the Chairperson are part-time appointees while the FASB members are all full-time appointees.

² Jamal and Sunder (2007) compare the FASB with The Internet Engineering Task Force (IETF), The Institute of Electrical and Electronics Engineers (IEEE), The Alliance for Telecommunications Industry Solutions (ATIS), and The International Telecommunications Union (ITU). The FASB is the most “top-down” oriented in its standard setting approach, slowest in developing standards, and least able to engage outside participants in its standard setting process.

³ For example, speed could be achieved by ceding decision making authority to sub-groups within the accounting profession. This is akin to the U.S. Court system where the Supreme Court justices do not have to attend to the many legal cases that are successfully adjudicated by lower level courts.

1700's (Condorcet's theorem 1785 – see the translation by Baker 1976) is that the larger the team of decision makers, the more likely they are to reach correct decisions. We will call this the “Neutral Judges Perspective.” The application of the Neutral Judges Perspective is conditioned on additional issues such as declining competence of each new member added. If there is a limited pool of talent for example, then the quality of decisions does not improve with an increase in size of the decision making committee. Thus, one interpretation of the stated desire to reduce the size of the FASB is a perceived decline in competence of the marginal members of the board even for its sixth and seventh members (see Karotkin and Paroush 2003 for an analysis of this quality versus quantity tradeoff). But the FAF does not make a declining marginal competence argument for its proposal.

If the members of FASB are thought of as voters who have pre-existing preferences or as representing constituencies, as opposed to neutral judges seeking the truth, then the relevant model to predict behavior would be that of the “Median Voter Theory” (Black 1948, Downs 1957). If preferences of FASB members can be arranged on a continuum (called single peaked preferences), the outcome of a vote will correspond to the preference of the median member of the group. According to Median Voter Theory, if there is a “core” group of voters, adding or subtracting voters will have no effect on the decision made as long as the preferences of new or removed voters distribute evenly on both sides of the preferences of the core group. In this case, if there is a core group that controls the board, adding voting members is mere window dressing creating the appearance of thorough representation of constituencies, without affecting decisions made. Subtracting members is likewise mere window dressing to create the appearance of greater efficiency.

The institutional design of the FASB presumes neutral judges (e.g., requirement to sever ties with previous organizations and insistence on neutrality of decision-making) with subject matter knowledge. Thus, the FASB is designed to comport with the Neutral Judges Perspective. It currently operates on the other hand, in a fashion more consistent with the Median Voter Theory. FASB members bring some pre-existing preferences⁴ and are chosen to provide special insight from and representation for various constituencies (e.g., investors, preparers, auditors). According to the Median Voter Theory, the size of the board will have no effect on FASB choices. The preferences of the “core” block of FASB members will prevail regardless of how many more members are added to or subtracted from the FASB. If the FASB were organized according to the Median Voter Theory, the FAF would be justified in arguing that reducing the size of the board will have no substantive effect on the decisions made.⁵ On the other hand, because the FASB has been (and should be) organized to reflect the Neutral Judges Perspective, the principal considerations for FASB size should reflect the principles associated with the Neutral Judges Perspective.

Therefore, we oppose the recommendation to reduce the size of the FASB because we prefer Board members that seek to develop a good standard (i.e., act as neutral judges), not to simply vote for their pre-existing preferences or constituency desires. In our opinion, the problems afflicting the FASB are due to its overly top-down orientation, excessive concentration of decision making, entrenched staff processes, and insufficient engagement, listening and concern for needs of users and preparers of accounting. These are all problems that further

⁴ Examples would include a potential member’s views regarding a more fair-value versus historical cost-based system or a more principles-based versus a more rules-based set of standards.

⁵ Although when no core block exists on a particular issue because of varied positions among all of the members, political strategies will be even more important in generating a decision (e.g., agenda controlling to reduce the alternatives on the table or vote trading when a member is not passionately advocating either side of this particular issue but would like another member’s support on another issue). A smaller committee makes this circumstance more likely.

concentration of the decision making power in the hands of an even smaller group of FASB members would exacerbate. Our interpretation of the evidence related to the performance of the FASB confirms that the problems the FAF hopes to ameliorate would not be solved by a reduction in the size of the Board. Rather, the need is for more bottom-up participation of the various interested communities, more competition for ideas, and more general acceptance of accounting standards.

In addition, reduction of the FASB size when combined with the second proposal for majority voting would create a situation where those holding the concentrated power would be even less inclined to genuinely listen to and evaluate a wide variety of views and to ensure that all stakeholders receive a full hearing of their views. Perceptions of a power concentration by other board members as well as interested stakeholders would reduce the incentive for individuals to offer views that contrast with those of the holders of the concentrated power. Similarly, those that hold concentrated power could pursue the agreement of the voting majority rather than seeking to engender general acceptance of proposals by their fellow members of the board as well as a majority of stakeholders as expressed in commentary communiqués. All of the above would deteriorate the general acceptance of the FASB as a merited independent private sector standard setting body seeking neutrality and optimal unbiased standards.

Retain the FASB Simple Voting Majority Requirement

Originally, a supermajority of the FASB (at least five of seven votes) was required to approve a proposal. The supermajority was recommended by the Wheat Committee in order to ensure general acceptance. If four Board members with common interests could pass proposals over the objections of other Board members, general acceptance might be in jeopardy. At that

time, their concern was related particularly to the four members assigned to the Board by the AICPA. In 1989, the requirement was changed to a simple majority because of concerns about the efficiency of FASB rule making and because the Board composition was changed and no longer contained any obvious four member voting blocks. This simple majority remains in force to this date.

Obviously, this question arises in various sectors of society. In the U.S. political arena, where the Median Voter Theory generally has prevailed, the modal voting system requires the simple majority. For example, court decisions including Supreme Court decisions, elections, and various committee structures used in the political process are simple majority votes. In the public sector, the simple majority vote is also the standard required by most boards and agencies although there are exceptions such as jury decisions, where unanimity or a super majority vote is required. In the private sector, there is more variation. Some standard setting organizations use a simple majority vote, some use rough consensus (with no formal vote), and some require a super majority of 70%, 75%, or even unanimity (Jamal and Sunder 2007). In the U.S., the modal voting system generally reflects situations dominated by political activity rather than expert activity. The FASB currently uses the simple majority system and often decides on its standards by a mere four to three simple majority vote (See Seidler 1990, for a complaint about lack of consensus in FASB decision making). The simple majority would become three to two if a Board size of five is passed and the simple majority standard remains.

Considering the authoritative status of FASB decisions, the high implementation costs for new rules, and significant sanctions enforced by the government for noncompliance, it seems reasonable to require that FASB members convince their fellow board members about the wisdom of the choices being made. How can the FASB's proposals achieve general acceptance

if they do not achieve general acceptance within the Board? Thus, we recommend that due consideration be given to returning to a super majority vote to ensure FASB standards are soundly based and have general acceptance in the accounting community regardless of the size of the Board.

Realign the FASB Composition

The third proposal is that the FASB composition be realigned. The FASB is currently comprised of three individuals with public accounting backgrounds, two with primarily user backgrounds, one with a preparer background, and one academic. Under the proposal, four of the seats would be allocated based on area of expertise as follows: one auditor, one preparer, one academic, and one financial statement user. The fifth seat would go to one “at-large, best-qualified member.” This proposal raises the issue of whether the FASB is composed of independent and neutral agents or representatives of constituencies. The FASB’s design presumes neutrality and independence of board members. Members must sever ties with previous organizations and the Board has neutrality as one of its fundamental principles. Yet the appointment process has become more like a political appointment process where each member is chosen to represent a constituency or at least provide the expertise and incentives of a particular constituency (e.g., auditor, preparer, investor), but without constituency votes.

This political appointment-like model violates a founding principle of the FASB, leading to inherent contradictions in terms of achieving neutrality and independence in fact and in appearance. If FASB members represent constituencies, then the FAF should identify relevant constituencies and decide how to represent them (e.g., should each group be equally represented?) and criteria for determining relevant constituencies as they change over time. If

the FAF seeks to renew emphasis on founding principles such as neutrality and independence, then a departure from the model that draws members from identified constituencies is warranted in favor of a model that seeks highly qualified but fiercely independent and neutral members.

Drop the Allocated Academic Seat on the FASB?

The above section contains the Committee's view on the proposal as stated by the Financial Accounting Foundation. On January 11, 2008 a Draft Discussion Memorandum from the SEC's Committee on Improvements in Financial Reporting (Pozen 2008) recommends that only three of the recommended members - a public accountant, a preparer, and an investor/user – have designated areas of expertise. We do not support this recommendation.

Throughout this commentary, we have expressed support for a model that seeks highly qualified and fiercely independent FASB members. Under this model, the key to the quality of the committee is the relative accounting knowledge of the candidate and the relative independent-mindedness of the candidate. The academic member is usually the most likely of all Board candidates to possess great accounting knowledge while also being fiercely independent.⁶ An academic member would have many fewer vested interests in the outcomes of deliberations than any other member. Moreover, academics are trained to consider all viewpoints in an unbiased manner before developing a conclusion. Academically-trained individuals bring the unique skills required to fully understand the context, findings, and implications of past research as well as unique ongoing access to this research. Thus, we find the recommendation from Committee on Improvements in Financial Reporting inconsistent with the principles on which the FASB is based.

⁶ For example, academic members warranting consideration for Board appointment are long-standing academics with tenured positions. Thus, it will have been a long time since the academic would have worked for any entity with a stake in the outcome of FASB deliberations.

Provide the FASB Chair with Decision-Making Authority to Set the FASB Technical Agenda

The final proposal related to the FASB is that the chair be endowed with ultimate agenda setting authority. The stated rationale for this proposal is to enable the FASB to “initiate and more quickly respond to pressing issues.” Secondly, the proposal is said to have the added benefit of “further facilitating and improving the interface with the International Accounting Standards Board (IASB).” Currently, the agenda setting process is a more democratic process within the Board supported by input from various organizations such as the Accounting Standards Executive Committee (AcSEC), the Auditing Standards Board of the AICPA, the Public Company Accounting Oversight Board (PCAOB), the International Accounting Standards Board (IASB), and the appropriate committees of such organizations as the CFA Institute, Financial Executives International (FEI), and the Institute of Management Accountants (IMA). The Board ultimately sets its agenda after considering the following factors about potential agenda items: the pervasiveness of the issue, alternative solutions, technical feasibility, practical consequences, convergence possibilities, cooperative opportunities, and resources.

The most powerful way for a “core” group in a committee or a chairman of the committee to control outcomes is by controlling the agenda. Control of the agenda limits the set of options considered by the committee, limits the information available to committee members about preferences of other committee members, and limits the set of voting strategies available. Indeed, theoretical and empirical evidence suggests that the most powerful way to depart from (or impose) the Median Voter Theory result is by controlling the agenda (see Plott and Levine 1978; Fiorina and Plott 1978).

Also, we find no anecdotal or empirical evidence to suggest that the agenda setting process has contributed significantly to the FASB's response time to pressing issues. Nevertheless, even if it is assumed that efficiency gains would result from endowing the FASB Chairperson with the responsibility for setting the Board's technical agenda, we view this further concentration of power not only unnecessary but also with costs that exceed any possible benefits. Certainly, the potential benefit is timeliness of reaction to issues that interest the Chairperson. On the other hand, further concentration of power in the Chairperson creates an atmosphere where stakeholders might not receive a genuine hearing of their issues or may not perceive it as worthwhile to even raise issues if the agenda-setting Chairperson's positions are known. Endowing the FASB chair with sole agenda setting authority is inconsistent with the goals of openness, innovation, and responsiveness to new ideas that we continue to support.

Possibly Another Agenda?

A recent article by Reason and Leone (2007) indicates that this FAF proposal is part of a more comprehensive strategy leading to the disbanding of the FASB in its current role with the remaining FASB members joining the IASB or becoming the IASB's outpost in the U.S. The response of the AICPA to this proposal also explicitly discusses the possibility of disbanding the FASB and developing U.S. representation on the IASB.⁷ If the Reason and Leone (2007) article faithfully represents the thought process of the FAF (and possibly the SEC), it is an example of a proposal being brought forth for reasons not limited to improving the financial reporting model. One motivation for us to emphasize the importance of competition in financial reporting standard-setting in this commentary and in our previous commentary (AAAFASC 2007a, 2007b) relates to the propensity for a monopoly standards-setter to adopt changes for non-substantive

⁷ The AICPA response can be found at <http://www.fasb.org/ocl/FAF-PCREQ/51919.pdf>.

purposes (e.g., political purposes). Concentration in standards-setting is unlikely to lead to the best financial reporting model. Absent competition, political forces and other incentives not primarily related to optimizing the accounting model are more likely to impact accounting standards-setting to the detriment of users of financial statement information worldwide.

Conclusion

Each of the four proposals related to the FASB contained in the FAF's "Proposed Changes to Oversight, Structure, and Operations of the FAF, FASB, and GASB" has serious problems and potentially adverse consequences for financial reporting. Subsequent approval of these changes by the FAF without addressing these concerns does not eliminate, even strengthens the case for their examination in accounting literature. We remain concerned that the standard setting process was potentially harmed by the changes. We do not believe that the FASB should be reduced from seven members to five members. We view the potential for reduced standard quality as too great to justify any efficiency gained by a 30% reduction in the intellectual capital on the Board. We do not support the decision to maintain the simple voting majority. We feel that standards expected to garner general support worldwide should be able to garner at least a supermajority of support within the Board. We do not support realigning the FASB composition. Instead, we feel that the FASB should be populated with the most highly qualified and independent thinking candidates regardless of background. Finally, we do not support granting agenda-setting authority exclusively to the FASB Chairperson. We view this as an unnecessary consolidation of standard-setting power.

We are not the only entity to express such concerns. For example, the official position of one of the two opining Big Four Accounting firms (Ernst & Young) did not support the reduction of the size of the FASB from seven members to five, expressed a preference for a supermajority

voting requirement especially if the Board size is reduced to five members, and expressed reservations about the proposals related to Board composition and agenda-setting authority. The National Association of State Boards of Accountancy and the Financial Executives International expressed similar reservations.⁸ Given the reservations expressed by such important stakeholders, the Committee noted with interest, the apparent ease with which the proposals were approved. To this end, we encourage the FAF to remain committed to transparency in its operations in general and to remain open to revisiting its recent actions affecting the FASB.

⁸ The response submitted by Ernst & Young can be viewed at <http://www.fasb.org/ocl/FAF-PCREQ/51920.pdf>, the response submitted by the National Association of State Boards of Accountancy can be viewed at <http://www.fasb.org/ocl/FAF-PCREQ/51888.pdf>, and the response submitted by Financial Executives International can be viewed at <http://www.fasb.org/ocl/FAF-PCREQ/51898.pdf>. The other opining Big Four firm (PWC) agreed with the proposal to reduce the size of the Board from seven to five, but worried about loss of expertise and recommended that a detailed competency description be developed for selection of FASB members. Likewise, PWC agreed with giving the chairperson power to set the agenda, but then wanted a limit set on the chairperson's power.

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