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Kinney, William R, Jr
Accounting Horizons; Jun 1996; 10, 2; ProQuest Central
pg. 180

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Accounting Horizons
Vol. 10 No. 2
June 1996
pp. 180–184

COMMENTARY

William R. Kinney, Jr.

William R. Kinney, Jr. is a Professor at the Unversity of Texas at Austin.

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It's a pleasure to discuss the Johnson and Swieringa paper about the *process* surrounding adoption of SFAS No. 115. The process for the Statement reveals much about the nature and functioning of the Board. My comments are influenced by a four-year term on the Financial Accounting Standards Advisory Council (FASAC), and recent service on the AICPA's Special Committee on Assurance Services (SCAS), chaired by Robert K. Elliott.

The SCAS is particularly relevant since its work is directed toward improving the reliability and relevance of information for decision makers. We usually think of auditors as assurers of financial information's compliance with established criteria, while judgments about what *should be* the criteria have been left to others. The FASB is the designated body for determining criteria assuring relevance of information for those who lack the authority to prescribe information that they want from management (SFAC No. 1). In effect, the FASB prescribes standardized data definitions, methods and boundaries for all companies that by, law, regulation or charter, must prepare general purpose financial statements following "generally accepted accounting principles." I will concentrate on the process to prescribe standardized data definitions and methods to be applied to yield a firm's "official earnings and assets."

The comments are organized as follows. First, I will discuss the Johnson and Swieringa (1996) paper and the process surrounding the development of SFAS No. 115. Second, the FASB's process will be tied to changes in information technology and their implications for accounting standards setting. I'll conclude with some questions whose answers might lead to process improvements.

THE SFAS NO. 115 PROCESS

Johnson and Swieringa (1996) provide a thorough and useful chronology of the events and issues leading to adoption of SFAS No. 115. The events begin in May 1986 with the introduction of the financial instruments project and end in November 1995 with the release of interpretative guidance. The relatively narrow issues addressed in SFAS No. 115 itself appeared on the technical agenda in June 1991 and ended with the adoption of the final statement in May 1993—23 months later. Without reading the Johnson and Swieringa article, one might conclude that these periods are simply "too long." They place the time periods into a context that allows some understanding of the lengths of the time periods.

The detailed listing of events captures the breadth and nature of the issues facing the FASB. The details of particular comment letters and other documents, notes of conversations and recollections of principal partici-

This commentary is based on the author's discussion of " L. Todd Johnson and Robert J. Swieringa's presentation at the AAA/FASB Financial Reporting Issues Conference held December 9, 1995 in Ann Arbor, Michigan. The author gratefully acknowledges the helpful suggestions of David Burgstahler, Katherine Schipper, Mary Stone and James Wahlen.

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pants provide a vivid picture of the positions held by various parties as to which an accounting method should be required for "official earnings." Without these details, one could easily fail to see both the importance of the issue to particular parties and the difficulty of any quick-fix compromise. I have comments on three major and three minor aspects of the FASB's process as evidenced by Johnson and Swieringa (1996).

The breadth of input is, perhaps, the most striking feature of the SFAS No. 115 process. In addition to eight federal agencies, each with different regulatory regimes and interests, we see preparers whose views differed depending upon whether they were financial institutions and whether they were preparing or analyzing financial statements. Below the surface of the arguments raised by various constituents, one can also see hints of underlying concern by the SEC with the overall mechanism of financial reporting and its potential effect on the viability of financial institutions. The fact that some of the events and pressures were not known to Board members at the time of the discussions is further indication of the subtleties of accounting-standards setting that depend, in part, on the outcomes of multiple political and regulatory processes.

While the breadth of input for SFAS No. 115 is striking, it is not unique. By chance, I received a sequence of events for "Accounting for Stock-Based Compensation" (SFAS No. 123) similar to figure A in the Johnson and Swieringa (1996) paper. The stock-based compensation sequence began November 1982, with the FASB's receipt of an AICPA issues' paper, and ended March 8, 1995, with a Board decision to prepare a final statement on stock compensation. Included in the sequence are 82 event entries covering $7^1/_2$ single-spaced pages with input from some of the parties noted by Johnson and Swieringa (1996), as well as comments by President Clinton. The views expressed and the interests in the Board's activities went well beyond considerations outlined in the FASB's Statements of Financial Accounting Concepts.

Notably lacking prominence in the sequence of events for SFAS No. 115, as well as from stock compensation and other controversial statements such as OPEB, are meetings with *users* of financial statements. If users, including individual and institutional investors, believe that the FASB is a critical mechanism for meeting their needs, then one would expect users, user groups or their agents to be more involved in the process of meeting with and lobbying the FASB on these issues.

Johnson and Swieringa (1996) also note the *deregulation* of financial institutions that preceded the interest of federal agencies in the subject matter of SFAS No. 115. In effect, accounting-based regulation was being explored as a substitute for direct regulation of these institutions by the government. This exploration accounts for some of the time needed to develop the final statement, and the regulatory role of accounting is potentially quite important. However, the best set of standardized data definitions for quasi-regulation is likely to be different from the set that best meets the needs of investors and creditors making investment decisions. Also, one might question whether the FASB's process is well suited to resolving these and other accounting-based regulation issues and resolving them in a timely manner.

A third important aspect of the process leading to SFAS No. 115, as noted by Johnson and Swieringa (1996), was the concurrent development in finance of what they call a "sea change." Part of the sea change in finance was due to the newly expanded investment horizons of financial institutions (i.e., deregulation), and part was due to risk management methods made operational by information technology. As to the latter, firms could now integrate and balance their risks on both the asset and liability side. Joint consideration of these risks makes sense in running a business, but it is far afield from the traditional accounting model that focuses on individual transactions and balances. An integrated approach makes sense in determining a net position, but it introduces a serious problem of determining the level of aggregation for accounting measures. One might question whether the FASB's process, that was developed in the 1970s based on the environment of the 1970s,

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is adequate for the 1990s. It seems unreasonable to ask that the Board deal expeditiously with individual issues, the dimensions of which were not contemplated in the 1970s because of technological infeasibility.

One minor aspect of the FASB's process reflected in Johnson and Swieringa (1996) is that SFAS No. 115 is unusual in that the issues divided the preparer community as well as regulators. The proposal favored by banks and other financial institutions was different from that favored by other preparer constituencies. In fact, as financial statement users, some banks favored mark-to-market for other financial statement preparers, but not for the banks themselves as preparers. Similarly the SEC's position and that of the Federal Reserve differed. The competing interests evidence the need for a process based on an established conceptual framework.

A second minor aspect in Johnson and Swieringa (1996) is the relation of SFAS No. 115 to the rest of the FASB's agenda. In particular, SFAS No. 115 occupied 7 percent of the Board's meeting time over 1991–1993, only 3 percent of staff time, overall, and 13 percent of the staff's time devoted to financial instruments during this period. The issues surrounding SFAS No. 115 were never the primary issues of the day, but were merely part of the mosaic of the items on the FASB's agenda at any one point. Thus, in evaluating the process and the outcome, one must keep in mind the competing demands for the Board's attention, and the need to balance and integrate various aspects of this project in the overall agenda.

A final minor aspect that should be mentioned is the unsubtle pressure under which the Board operated immediately prior to the SFAS No. 115 deliberation period. In 1990, there were three proposals to the Financial Accounting Foundation to alter the Board's operations. First, there was a proposal for a one member increase in the preparer community's representation on the Board. Second, there was a proposal for an "annual review" of each board member in order to give the board member early feedback on how well he or she was fulfilling his or her responsibilities. Third, there was a proposal for super majority for adoption of a statement.

All three proposals would likely have affected the Board's process and output. The first would increase the voice of preparers who, as a group have incentives to prefer fewer standards, the second would allow intimidation of Board members and the third would likely slow the adoption process by requiring more support for adoption. Only the third proposal was implemented and, while one can only speculate as to the intent behind the proposals, at least FASAC's support for them was not random. I can recall one particularly testy meeting in which a member ended the discussion and straw poll by stating "let it be noted that all FASAC members in favor of this proposal are from the preparer community."

INFORMATION TECHNOLOGY

To further evaluate the adequacy of the FASB's agenda process, I would like to consider other effects of changes in information technology on the relevance of the present system of public reporting. As Johnson and Swieringa (1996) note, sophisticated risk management is one result of the change, but there are changes on the production and accounting sides as well. These changes imply that even if we could somehow speed up the FASB's process for individual issues, the value of the overall system of audited financial statements based on generally accepted accounting principles might still decline.

Consider a company studied by the SCAS—I will call it George's Electronics. George's Electronics designs, manufactures and markets electronic security equipment through a major discount super store chain. George's employees include a design staff, some information workers and little else. His crack engineering design staff develops new products and product specifications, which are produced by South Korean manufacturers through short term alliances. The goods are then sold to a major super store discount chain.

George sells more than $100 million of security equipment per year, but his financial statements look quite different from those of

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traditional manufacturers and distributors. In particular, George has *no receivables*—the super store transfers funds electronically upon receipt of merchandise. He has *no inventory*—product quantities that George manages are on the books of the super store and the in-transit UPS pipeline from Korea to Arkansas, Michigan and Vermont. Even though he has no inventory, George can determine his customer's inventory quantities and current sales for any super store by logging onto his portion of the super store's on line inventory. He can determine the Korean's in-transit inventory by accessing UPS's worldwide package tracking system. Similarly, George has no *manufacturing facility* or production capacity costs because all production is by South Koreans.

George's footnotes include many lines describing employee pensions and other post-employment benefits. However, George is considering accounting for each employee as a supplier "firm," with separate accounting for each. This would eliminate footnotes for pension liability, as well as other post-employment benefits. While accounting for each employee/firm would be novel, the savings to George may be substantial. George's important assets include the human resources on the design staff, the good will of super store management and an alliance with reliable Korean manufacturers. None of these "market-based" assets is recorded on George's balance sheet (see Srivastava and Shervani 1996). Innovative ways of measuring and reporting these firm market-based assets might add significantly to the aggregate value of a system of audited financial reporting.

Related phenomena have been noted in a large sample study of the wireless communications industry presented by E. Amir and B. Lev at the 1995 *Journal of Accounting and Economics* Conference on Contemporary Issues Financial Reporting. The authors studied stock prices and accounting earnings and book values of firms in the cellular telephone industry. They found essentially zero correlation between accounting variables and stock market measures of firm value. This lack of association should be disturbing to accountants since both types of measures are based on the same underlying phenomena. Amir and Lev (1995) report that there are other (nonfinancial) measures that are highly correlated with stock prices, specifically, the numbers of actual and potential customers of the companies. Standardized formats for reporting non financial measures of market-based assets might be developed and integrated with the system of audited financial reporting.

WHERE DO WE GO FROM HERE

There are many unanswered questions about the implications of the process surrounding SFAS No. 115. Here are three that trouble me:

Question 1—Why Do "Official Earnings" Matter so Much to Preparers?

In the case of SFAS No. 115, mark-to-market information is available in footnotes. The same ideas apply to SFAS No. 123 on stock compensation. Yet, booking these numbers in official earnings was not satisfactory to major preparer groups. It seems unlikely that accounting-dependent contracts alone fully explain the opposition to the mark-to-market accounting for banks and other financial institutions. Incorporating the answer to this question might better focus the FASB's conceptual framework. Two papers presented at the 1994 AAA/FASB Financial Reporting Issues Conference provide several interesting views on these questions and document research results. Specifically, Holthausen and Palepu (1994) explored economic consequences, and Bernard and Schipper (1994) distinguished recognition and disclosure issues.

Question 2—Can the FASB be Expected to Deal Effectively with Political and Regulatory Issues?

In my view, the accounting aspects of SFAS No. 115 are relatively straight forward, and amenable to a rather straight forward prescription. Yet, the Board did not arrive at an answer in a straight forward fashion. The missing links are the political/economic aspects surrounding the issue. A political science/economics approach, characterized by constituencies with conflicting objectives, dif-

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fering costs and benefits for a particular rule, and differing incentives and abilities to lobby the FASB, might allow prediction of the statement eventually adopted. If this is true, then those who wish to conduct accounting standards setting research should be advised to study political science as well as economics.

Question 3—Is the FASB's Conceptual Framework a Sufficient Basis for Financial Reporting as a Source of Relevant (and Reliable) Information about Businesses in the Twenty-First Century?

One can see the potential importance of this question by merely extending the SCAS and the Amir and Lev (1995) findings into the future. In 2001, are major firms more likely to be similar to George's Electronics and the telecommunications firms, or to Bethlehem Steel and Mary's Corner Store?

Transactions-based accounting reports have comprised the only comprehensive and integrated information system providing comparable information across firms. Now there are many competing information sources that provide more relevant (and timely) information *on aspects* of an entity. Someone should consider the optimal role of a *system* of prescribed disclosures to be prepared by all entities. The system would include standardized data definitions for official earnings, and could be highly useful for stewardship, performance evaluation, and measurement of economic activity. As to process, preparers can help assess the individual costs of alternative prescriptions, but are of limited value in judging their aggregate benefits.

Thinking selfishly, we need ways for those who call themselves *accountants* to measure the value of human resources, alliance relations, intangibles and market-based assets that were considered insufficiently important, unnecessary or impossible to measure in an earlier age. We also need "value at risk" measures that reflect risk characteristics of new financial instruments and perhaps other assets. In addition, we should consider means of measuring and integrating important nonfinancial measures. Finally, we should recognize that with information technology, it will be economic to provide a vector of values for financial statement elements as well as related nonfinancial measures. Users will value the ability to customize or "roll their own" analyses from the accountants' integrated data base.

A revised conceptual framework should recognize that *official earnings and assets* have a role, and perhaps, a unique usefulness. Without saying what this role (or roles) might be, it seems clear that a set of "one-size fits all" financial numbers, published 13 to 15 months after the beginning of a fiscal year and using a conceptual framework from another era, can not be expected to be a primary information source for all or even most financial decisions that a user might wish to make.

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