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Towards an understanding of the role of standard setters in standard setting ☆

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ABSTRACT

We investigate the effect of standard setters in standard setting. We examine how certain professional and political characteristics of FASB members and SEC commissioners predict the accounting “reliability” and “relevance” of proposed standards. Notably, we find FASB members with backgrounds in financial services are more likely to propose standards that decrease “reliability” and increase “relevance,” partly due to their tendency to propose fair-value methods. We find opposite results for FASB members affiliated with the Democratic Party, although only when excluding financial-services background as an independent variable. Jackknife procedures show that results are robust to omitting any individual standard setter.

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1. Introduction

As the Financial Accounting Standards Board (FASB) closes in on four decades, the role of its standards in shaping U.S. and international corporate reporting is widely acknowledged. An empirical literature on the political economy of FASB standard setting has emerged over that period to explore the origins of accounting standards largely through an analysis of constituent comment-letter lobbying (e.g., Watts and Zimmerman, 1978). But such comment-letter lobbying is only part of the political economy that determines accounting standards (e.g., Ramanna, 2008, studies the role of congressional intervention). At the core of the standard-setting process are the individuals that comprise the FASB and its sanctioning authority, the Securities and Exchange Commission (SEC). In this paper, we develop and test some exploratory hypotheses with a view towards building an understanding of the role of FASB and SEC regulators in U.S. GAAP.

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Although the idea that FASB and SEC regulators can matter in standard setting is intuitively appealing, it has not been subject to empirical testing. This is due in part to limited data availability, but also in part to neoclassical economics, which is widely used in accounting research and tends to view "individuals" as "so empirically unimportant as to allow the use of Occam's razor in positive models" (e.g., Kalt and Zupan, 1984, p. 279). Recently, however, empiricists in finance and accounting have begun exploring the role of individuals on equilibrium outcomes, particularly in the context of individual managers and firm policies (e.g., Bertrand and Schoar, 2003; Bamber et al., 2010; Dyrenge et al., 2010). Moreover, in the regulation literature itself, there is some evidence of regulators' preferences mattering in outcomes at both the congressional (e.g., Kau and Rubin, 1979) and the bureaucratic agency levels (e.g., Gormley, 1979). Thus, in the context of accounting standard setting, tests of influence of FASB and SEC regulators can help refine our understanding of the political economy of U.S. GAAP.

We conduct our study through an analysis of FASB exposure drafts proposed from 1973 (the FASB's inception) through 2007. There are 149 such exposure drafts in our sample after data limitations. Our primary tests involve regressing assessments of the nature of an exposure draft on the average background characteristics of extant FASB and SEC regulators.

We evaluate a proposed Statement of Financial Accounting Standards (SFAS) by focusing in particular on its impact on accounting "relevance" and "reliability"—two characteristics usually cited as fundamental accounting properties in accounting textbooks (e.g., Stickney et al., 2010, pp. 23, 114). There are no obvious metrics to use in evaluating exposure drafts; our choice of "relevance" and "reliability" reflects our judgment on their importance to accounting. Since at least the publication of its conceptual statements in the late 1970s (e.g., FASB 1978, 1980), the FASB itself has viewed "relevance" and "reliability" as "the two primary qualities that make accounting information useful for decision making" (FASB, 1980, p. 5), adding that "serious disagreement" often arises "about whether the superior relevance of the results of one [accounting] method outweighs the superior reliability of the results of [another]" (FASB, 1980, p. 8). Moreover, the increased prominence, since the mid-1990s, of fair-value accounting in standard setting has generated additional interest in the "trade-off" between "relevance" and "reliability." The FASB has often justified the increased use of fair values by arguing it will increase the "relevance" of accounting numbers (e.g., Johnson, 2005). In contrast, some academics have argued accounting estimates generated under fair-value accounting will decrease the "reliability" of financial reports (e.g., Watts, 2003).[1]

To obtain assessments of exposure drafts' impact on "relevance" and "reliability" that are independent of researcher judgment, we develop a measure based on comment letters filed by the Big 8/6/5/4 auditors (hereafter, "Big N auditors"). There are 908 such comment letters in our sample after data limitations. The advantage to using Big N auditors' comment letters is that they are available on most exposure drafts in our sample period and are contemporaneous (i.e., no hindsight bias). The letters are, however, likely to reflect the auditors' private incentives, which can confound inferences if endogenous to our explanatory variables (i.e., the characteristics of FASB and SEC regulators). To mitigate this concern, in robustness tests we use an alternative assessment of the exposure drafts from two seasoned research assistants (with over 30 years of combined experience in accounting) blind to the objective of this study.

We build a biographical database of all 39 FASB members and all 41 SEC commissioners serving between 1973 and 2007. Drawing on empirical political-economy research that has examined the characteristics of regulators on regulation (see Dal Bo, 2006, for a review), we focus on two sets of characteristics: professional and political. The professional characteristics are length of regulatory tenure, industry background in auditing, and industry background in investment banking/investment management (hereafter, "financial services")[2]; the political characteristics are affiliations, if any, with the Democratic and Republican parties. Prior research has consistently found high correlations between regulators' professional and political characteristics and so has examined these characteristics both independently and jointly in multivariate regressions. We adopt this approach in our empirical design.

In examining professional characteristics independently, we find that longer average FASB and SEC tenures are associated with exposure drafts perceived by auditors as decreasing accounting "reliability;" but, we find no evidence of an association between the regulators' tenures and exposure drafts' "relevance." If decreased "reliability" is an undesirable property of accounting (e.g., Watts, 2003), the result is consistent with longer regulatory tenures compromising accounting quality.[3] Concerning industry backgrounds, we expect regulators with prior employment in auditing to be more sympathetic to accounting "reliability" (since "reliable" accounting lowers auditors' litigation risk; e.g., Watts, 2003); in contrast, we expect members with prior employment in financial services to be sympathetic to valuation-relevant accounting (e.g., ICI, 2008), and thus more likely to promote "relevance" at the expense of "reliability" (e.g., Johnson, 2005). We do not find results associating regulators' careers in auditing with "reliability" and "relevance." However, we find evidence that exposure drafts proposed by FASB members and SEC commissioners with prior experience in financial services are viewed by the Big N auditors as decreasing accounting "reliability." Further, in the case of FASB members, experience in financial services is associated with exposure drafts viewed by the Big N auditors as increasing accounting

[1] While "reliability" and "relevance" can be trade-offs in some circumstances, it is an empirical question as to whether these concepts are always at odds with each other.

[2] When studying industry background, the regulatory literature has focused on industries most closely associated with the regulations being studied. In our setting, we focus on auditing and financial services, viewing them as front-line intermediaries in the production and use of accounting information.

[3] Stigler (1971) argues that longer regulatory tenures compromise regulation by promoting greater "coziness" between regulators and the regulated.

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