



---

Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | [www.law360.com](http://www.law360.com)  
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | [customerservice@portfoliomedia.com](mailto:customerservice@portfoliomedia.com)

---

## Federal Takeover Of Financial Reporting Standards

*Law360, New York (July 09, 2009)* -- The current administration's seemingly primary approach to addressing successive crises is to broaden the scope of government authority and to implement, or propose, additional regulations.

Congress was thus receptive when representatives of the financial services industries, and in particular the American Bankers Association, lobbied heavily to expand government influence, or impose government controls, over the accounting standard setting process that has historically been the domain of the private sector.

Based on their perception or belief that the Financial Accounting Standards Board (FASB) was reluctant to consider the appropriateness of modifying — or even suspending — adherence to certain fundamental accounting principles during times of economic distress, these interests urged Congress to replace the U.S. Securities and Exchange Commission with another government body willing and able to exert additional pressure over FASB.

Convinced that such government intervention was appropriate, Reps. Ed Perlmutter, D-Colo., and Frank Lucas, R-Okla., responded by introducing H.R. 1349, The Federal Accounting Oversight Board Act of 2009, on March 5.

If enacted, this bill will propel our current common-law-tradition accounting system substantially toward that which exists under the code-law regimes.

A code law approach (where everything is prohibited unless explicitly authorized) has never (with the exception of in Louisiana, based on its Napoleonic Code history) been embraced in the United States, which follows the English common law tradition (where everything is permitted unless expressly prohibited).

This fundamental change in the standard-setting process will have serious long-term, and likely irreversible, ramifications.

It appears that critics of the current structure do not fully appreciate how the private and independent status of the FASB, albeit imperfect, has contributed mightily to the integrity of our financial reporting system.

Politicization of accounting standard setting and financial reporting standards will diminish the usefulness of accounting information. H.R. 1349, if passed, will expand the Government's authority, and may well ultimately result in the lessening of investor trust in the capital markets.

The extent to which the legal tradition of a nation exerts influence on the nature of its financial reporting system is widely under-appreciated. There are two main legal traditions: code law and common law.

In countries with a common law tradition — the U.S., Australia, Canada, and the United Kingdom — the establishment of accounting standards has remained distinct from national law. In those jurisdictions, accounting originally evolved through the process of becoming generally accepted in practice.

Later, detailed accounting regulations were produced by professional organizations or other private sector bodies, building and improving upon those time-honored practices.

Adherence to these standards is then left up to professional accountants and auditors, who are expected to apply reasonable judgment, and who are answerable to professional enforcement bodies (augmented by fear of the legal process, when they fail to do so).

Those who favor accounting systems based on a common rather than code law approach contend that this produces greater responsiveness to evolving financial reporting needs, timelier production of financial information that lubricates the functioning of the capital markets, and optimal corporate efficiency.

Litigiousness is a necessary, if often reviled, aspect of such a standard setting regime; a price that has to be paid to enjoy the fruits of a system that is free to evolve to meet the changing demands of the investor community.

The code law tradition is almost diametrically opposite to the common law approach. Accounting regulation rest in the hands of the government in countries that operate under a code (or civil) law system, such as Germany, France, Italy, Belgium and Spain.

Financial reporting in such countries means compliance with a set of prescribed rules that have been incorporated into the law of that country. What is unique to this system is the fact that the government — and those best positioned to exert political influence — have direct control over financial reporting standards.

This puts the government in a position to manipulate accounting standards to advance particular political agendas, and, coupled with its prosecutorial powers, gives it an

absolute level of authority that can preclude the development of market-responsive financial reporting practices.

In the U.S., the FASB plays a central role in the common-law-oriented accounting standard-setting system. It promulgates GAAP for both private and public companies — the latter courtesy of the fact that the SEC, which by law could have been establishing accounting standards since 1934, has (with very rare exceptions) ceded that authority to the private sector, and has recognized the primacy of the FASB since its creation in 1973.

Notwithstanding the SEC's role as overseer of the standard-setting process, the FASB is not a government body. Despite a few missteps over the years, when it has bent to political pressures, the FASB has been quite successful in maintaining its independence and objectivity in discharging its standard-setting duties.

Its standards, based on a conceptual framework that holds neutrality and freedom from bias as key criteria, have well served the interests of external users, rather than those of management seeking to conceal economic anguish.

H.R. 1349 is still in the first stages of the legislative process and is currently with the House Committee on Financial Services undergoing the typical procedures of deliberation, investigation, and revision.

If enacted, H.R. 1349 would amend the Securities Act of 1933 and the Securities Exchange Act of 1934, and would remove from the SEC its oversight of the FASB, which would reside with a new Federal Accounting Oversight Board (FAOB).

The FAOB would be tasked with approving the issuance of, and overseeing the development of, accounting principles and financial reporting standards, “for purposes of the Federal financial regulatory agencies and reporting requirements required by such agencies.”

Those agencies would include OTS, FDIC, NCUA, the SEC, the Federal Reserve System and the Office of the Comptroller of the Currency.

Thus all financial institutions and all public companies would have their accounting standards explicitly under the direct control of this new board, which would be composed of the chairpersons of the Federal Reserve, SEC, FDIC, the Treasury secretary and the chair of the PCAOB — nonaccountants, all.

Although H.R. 1349 would not immediately change GAAP, it does set out a framework to review the application of current and future GAAP.

Certain major changes would be fairly predictable, since the bill explicitly calls for the board to consider, inter alia, the extent to which accounting principles “create systemic

risk exposure,” and whether “certain accounting principles and standards should apply to distressed markets differently than well-functioning markets.”

This clearly evokes the recent demands for the loosening of fair value accounting requirements, some of which the FASB, threatened with the usurpation of its role by Congress, has already enacted.

The goal of the sponsors of this bill could thus scarcely be more transparent: to put accounting standards at the service of those who would mandate social and economic policies based on their own political philosophy.

As proposed, federal financial regulatory agencies would be allowed to request that the FAOB review any extant or proposed accounting principle or standard that it determines has a negative and unnecessary impact on the nation’s economy or on an entity that the agency regulates.

The agency (e.g., OTS) requesting such a review will be entitled to exercise discretion and given the right to ignore that particular provision for a period of 30 days, unless extended by the FAOB. In other words, GAAP could be temporarily suspended pending FAOB action.

If this process had been in place in 2008, mark-to-market requirements for bank investments could have been suspended by OTS, FDIC or OCC, leaving banks, for example, able to maintain devalued investments on their published balance sheets at historical cost (or a previously reported fair value), which would not have reflected current conditions.

Strategically timed, such actions could have affected not merely individual investments decisions, but even the outcome of national elections.

In discharging its proposed duties, the FAOB would be required to consider these 10 factors:

- 1) The extent to which accounting principles and standards create systemic risk exposure for the U.S. public, the U.S. financial markets, and global financial markets;
- 2) The extent to which various accounting principles and standards resolve questions concerning liquid and illiquid instruments;
- 3) Whether certain accounting principles and standards should apply to distressed markets differently than well functioning ones;
- 4) The balance between investors’ need to know a value of a company or financial institution’s balance sheet at any given time versus financial regulators’ responsibility to examine a company or financial institution’s capital and value on both a liquidation and going concern basis;

- 5) The accuracy and transparency of financial statements;
- 6) The ability of investors and regulators to accurately judge the current and long term financial condition of companies and financial institutions from their financial statements;
- 7) The need for accounting principles and standards to take into account the need for financial institutions to maintain adequate reserves to cover expected losses from assets held by such intuitions;
- 8) The extent to which accounting principles and standards can improve the usefulness of financial reporting by focusing on the characteristics of relevance and reliability and on the qualities of comparability and consistency;
- 9) The extent to which such principles and standards can be kept current to reflect changes in methods of doing business and changes in the economic environment; and
- 10) Any other factors that the FAOB considers appropriate.

The overwhelming orientation toward “helping” financial institutions with their financial reporting problems is apparent, and reflects faithfully the motivations behind the proposal.

Given this context and the high profile of the fair value controversy in the popular press, coupled with the political appointee makeup of the proposed Board, the likelihood for financial reporting mischief would appear to be significant.

Those who remember the thrift and banking crises of the late 1980s and early 1990s may recall the experience with government-mandated “supervisory goodwill accounting,” which was imposed to delay recognition of the true condition of lending institutions.

When, in a stunning legislative flip-flop (enactment of FIRREA of 1989 and then FDICIA of 1991) Congress stripped them of these regulatory “good assets” and precipitated the seizure of hundreds of thrifts and banks, many of these failed institutions or their owners later (after the Supreme Court’s 1995 Winstar decision) collected billions of dollars of damages from the taxpayers.

This still-recent experience with politically driven accounting standards should be an object lesson to our current legislators, although thus far this seems not to have drawn much attention.

FASB chair Robert Herz valiantly fought congressional interference and, by some measures, escaped the experience with the FASB’s integrity mostly (but clearly not fully) preserved.

The changes that would likely be wrought by the Federal Accounting Oversight Board Act of 2009, however, would make another such performance nonfeasible and usher in a new era of policy-driven financial reporting standards.

It would create a system that has been tried and found wanting by nations having a code law tradition, and should be anathema to those who believe in this nation's common law approach, which is largely mirrored in our process for the development of financial reporting standards.

World War I-era French statesman Georges Clemenceau once famously observed that "war is too important a matter to be left to the military." So, too, are financial reporting standards too important to be left to the politicians. This proposal deserves to be publicly exposed, vigorously debated and defeated.

--By Barry Jay Epstein and Elaine Vullmahn, Russell Novak & Company LLP

*Barry Jay Epstein, Ph.D., CPA, is a partner with Russell Novak & Company LLP in the firm's Chicago office, as well as co-author of Wiley GAAP 09, Wiley IFRS 09, Wiley IFRS Policies and Procedures and other books. Elaine Vullmahn, MBA, CPA, CIA, is a senior litigation accountant with the firm in the Chicago office.*

*The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.*