

Karthik Ramanna*

Unreliable Accounts: How Regulators Fabricate Conceptual Narratives to Diffuse Criticism

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Abstract: In 2010, the U.S. accounting rulemaker (FASB) updated its long-standing constitution to eliminate “reliability” as a fundamental accounting property. FASB argued that “reliability” was misunderstood in practice and that this amendment clarified its original intent. Drawing on primary archival resources and field interviews with regulators, I provide evidence that the change also sought to legitimize the rise of fair-value accounting. By eliminating the need for accounting to be “reliable,” the change attempted to neutralize concerns about the subjectivity in fair-value estimates. Such subjectivity can facilitate accounting manipulation, and some fair-value rules can be attributed to lobbying by managers who stand to benefit. The change illustrates “conceptual veiling,” wherein regulators, seeking to diffuse criticism, including suspicions of capture, manufacture costly conceptual narratives for justifying their actions.

Keywords: capital markets, fair-value accounting, FASB, regulatory capture

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***Corresponding author: Karthik Ramanna**, Blavatnik School of Government, University of Oxford, Oxford, UK, E-mail: karthik.ramanna@bsg.ox.ac.uk

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1 Introduction

Consider that as a parent you are concerned about low levels of mathematics attainment in your child’s school. You raise this concern with the school’s board. The board proposes using a new technology – a smart-phone app – that is said to improve children’s learning in mathematics. A number of experts emerge to support the school board. The app plan is launched.

The school year progresses and it becomes apparent that the app isn’t improving mathematics learning outcomes. Over time, it also becomes clearer that the “experts” are not in fact independent; they are affiliated with the app’s manufacturers. You start to worry. Was the school board conned, or worse, coopted, by vested interests, you wonder.

You raise this new suspicion with the school board. The board declares that the app’s objective was never to improve mathematics learning outcomes; rather, it was to help students adopt new technologies. This, the app is doing, they note, and your worry is therefore unwarranted.

Would you be satisfied?

I expect not. The school board's position defies basic principles of accountability. The school board has arbitrarily shifted its justification for the app to avoid being held to account on its original justification.

Yet, this scenario is similar to what we have experienced in recent years from the boards that determine the generally accepted accounting principles (GAAP) for listed corporations in the U.S. and much of the world. And it has gone largely unchallenged.

Why should one care? Because these standards are expected to hold corporations and their managers to account: the standards, if functional, are instrumental in safeguarding our collective savings and investments in capital markets, together with meeting other objectives of corporate financial reporting.

The situation with the accounting boards betrays a more general concern with regulatory behavior in esoteric areas of the economy where public knowledge of, and interest in, the relevant details is sparse. Faced with little public accountability, regulators can become distant from the ordinary citizens they are expected to serve. Rather, the regulators can find themselves more often in contact with “experts,” who may have an agenda to drive.

In these circumstances, the regulations start to favor the views of the experts. The regulations look captured by the special interests, eventually putting the regulators on the defensive.¹ Here, they can respond by weaving new narratives that are intended to insulate themselves from claims of bias and dereliction.

In the case of the accounting boards, they have gone so far as to incorporate these narratives into formal promulgations of the objectives of corporate reporting mainly contained in accounting's conceptual frameworks. Such changes are akin to changing the “constitution” of accounting standards to deflect criticisms about capture. For instance, as I will describe in this article, our accounting boards now argue that “reliability” is no longer a necessary property of GAAP. The shift is especially jarring as reliability has long been viewed as an existential property of accounting.²

To understand how we got here, we must start with a brief overview of one of the most important developments in financial reporting over the last three decades: fair-value accounting.

Fair-value accounting refers to the practice of recording assets and liabilities on corporate books at estimates of their current value. Sometimes those current

¹ See e.g. Elmer E. Schattschneider, *The Semi-Sovereign People: A Realist's View of Democracy in America* (1960); Pepper D. Culpepper, *Quiet Politics and Business Power: Corporate Control in Europe and Japan* (2010).

² See e.g. See William Paton & A.C. Littleton, *An Introduction to Corporate Accounting Standards* (1940).

values are observable through prices for similar items in liquid markets. Sometimes the assets and liabilities are so unique that comparable prices are not available. Here, the valuations are often provided by experts based on assumptions supplied by the reporting entities themselves.

The use of fair-value accounting contrasts with the time-honored practice of recording corporate assets and liabilities at their acquisition costs from realized arm's-length transactions. Under this practice, these amounts are depreciated or written-off if their future benefit potential is depleted, but they are not written up, even if there are indications that their current values have increased. This form of accounting practice is known as historic-cost accounting.

The inherent conservatism of historic-cost accounting (write-downs, but no write-ups) helps prevent corporate managers and other insiders from overstating gains even as it requires timely information on losses.³

While the use of fair-value accounting in the U.S. and worldwide has grown in recent decades, it is not a new phenomenon. The practice had been employed through the roaring 1920s, and, indeed, it was implicated in some measure in the market manipulations that were associated with the Great Crash of 1929.⁴

For instance, Robert Healy, who directed a congressionally mandated investigation into dubious accounting practices by public utilities in the 1920s, noted the use of write-ups in that period "to create income or to relieve the income accounts of important charges."⁵

The period from the 1930s through the 1980s saw very little fair-value use in U.S. GAAP. Accounting historian Stephen Zeff attributes this fact largely to a regulatory moratorium motivated by experiences of fair-value abuse in the 1920s. Zeff notes, in particular, how key personalities at the U.S. Securities and Exchange Commission (SEC) were instrumental in instituting and enforcing this ban.⁶

But starting in the early 1990s, the proportion of U.S. accounting rules using fair values grew substantially, a pattern that persisted at least through the 2008 Financial Crisis, whereafter the growth has been more modest. (See Figure 1 for the proportion of GAAP proposals from 1973 to 2008 using fair-value methods.)

This initial unleashing of fair-value accounting after the decades-long moratorium may have been well-intentioned. The early 1990s was the period following

³ See e.g. Robert W. Holthausen & Ross L., *The Relevance of the Value-Relevance Literature for Financial Accounting Standard Setting*, 31 *J. Acc. & Econ.* 3, 3–75 (2001); S. P. Kothari, Karthik Ramanna & Douglas J. Skinner, *Implications for GAAP from an Analysis of Positive Research in Accounting*, 50 *J. Acc. & Econ.* 246, 246–286 (2010).

⁴ See Stephen A. Zeff, *The SEC Rules Historical Cost Accounting: 1934 to the 1970s*, 37 *Acc. & Bus. Res.* 49, 49–62 (2007).

⁵ Robert E. Healy, *The Next Step in Accounting*, 13 *Acc. Rev.* 1 (1938).

⁶ Zeff, *SEC Rules*.

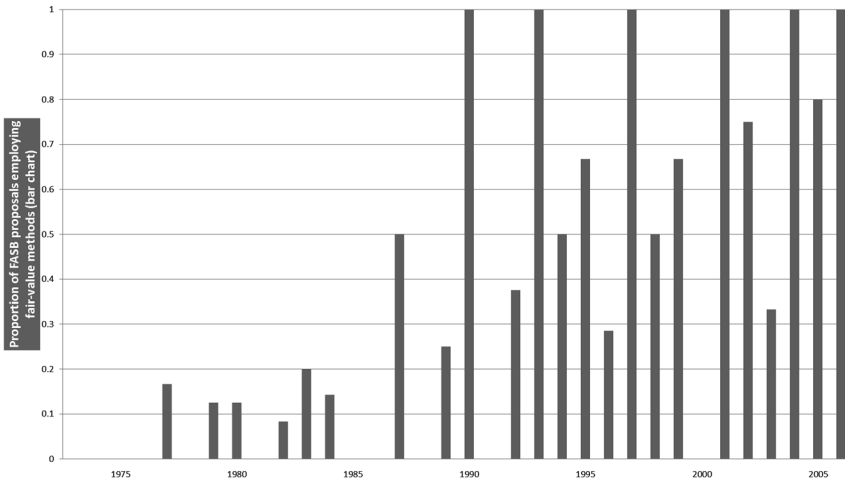


Figure 1: Graph representing the shift to fair-value methods by the FASB.

Source: Data from Abigail M. Allen & Karthik Ramanna, *Towards an Understanding of the Role of Standard Setters in Standard Setting*, 55 *J. Acc. & Econ.* 66–90 (2013).

the savings-and-loan crisis in the United States, where there were some concerns that historic-cost accounting had left investors with an outdated picture of the health of important financial institutions. In particular, accounting practices were thought to have been slow to recognize losses on investment portfolios.⁷ And, in this initial stretch, the use of fair values was generally limited to assets and liabilities with observable prices in liquid markets.⁸

Moreover, there are certainly situations where the use of fair values can be preferable to historic-cost accounting. One such situation is when it comes to estimating liabilities associated with the derivative and hedge contracts firms enter into for risk-management purposes. Here, fair-values estimates, albeit noisy, can provide some indication of corporate downside exposure.⁹

⁷ See e.g. Joni J. Young, *Getting the Accounting ‘Right’: Accounting and the Savings and Loan Crisis*, 20 *Acc., Org. & Soc.* 55, 55–80 (1995) (studying the role of accounting in the savings-and-loan crisis).

⁸ Even this limited use of fair values does not preclude the procyclicality of such measurements stemming from any inefficiency in market pricing. See e.g. Yuri Biondi, *Fair Value and the Formation of Financial Market Prices Through Ignorance and Hazard*, 16 (2018, eds. Gilad Livne and Garen Markarian).

⁹ The problem chiefly arises when the hedging contract involves nominal or zero cash-exchange at signature but exposes the signatories to significant contingent liabilities.

But the fair-value genie has been hard to contain. Fair-value methods are now deployed in many other asset and liability classes, where valuation estimates are, at best, intelligent guesses. In these cases, asset and liability valuation estimates have to be generated from mathematical models using a number of subjective assumptions about future economic conditions, including growth and interest rates, a practice that is not verifiable.¹⁰

The lessons that were learnt in the 1920s – in the words of the SEC Commissioner Robert Healy, “the purpose of accounting is to account—not to present opinions of value” – have been seemingly unlearned.¹¹

Perhaps the most glaring single-company example of fair-values gone wrong comes from Enron, the poster-child for accounting chicanery. For instance, in the year 2000, Enron recognized a profit of over \$110 million based largely on signing a contract with the film-distribution company Blockbuster to supply video-on-demand to American households. What was especially remarkable was that Enron had not delivered, or even developed, much of the necessary technology to make this deal a reality.¹²

But using some heroic assumptions, lightly veneered in fair-value methods that obviated the need for reliability, Enron booked the profit. From the year 1995–1999, Enron stock had underperformed the S&P 500 index. But in the year 2000, fueled in part by accounting manipulations such as this, Enron stock wildly outperformed the S&P benchmark. Not surprisingly, the following year brought a massive payday for Enron executives.¹³

And then a year later, the fraud unraveled and the company was finished, but not before doing damage to scores of customers, employees, investors, and competitors.

Where Enron is a case of what a single company can do with fair-value accounting, the period of the early and mid-2000s, leading up to the 2008 Financial Crisis, tells the story at the level of the economy as a whole. This was a

10 Fair values are generally more common across financial versus non-financial assets and liabilities, and there is some evidence to suggest that market forces appear to discipline the use of unverifiable fair-value estimates across non-financial assets. See Hans B. Christensen & Valeri Nikolaev, Does fair value accounting for non-financial assets pass the market test?, 18 Rev. Acc. Stud. 734, 734–775 (2013).

11 Healy, at 6.

12 See Paul M. Healy & Krishna G. Palepu, The Fall of Enron, 17 J. Econ. Persp. 3, 3–26 (2003).

13 See e.g. Kurt Eichenwald, Enron's Many Strands; Executive Compensation, New York Times (March 1 2002), <http://www.nytimes.com/2002/03/01/business/enron-s-many-strands-executive-compensation-enron-paid-huge-bonuses-01-experts.html> (last visited November 2017).

time when securitizing subprime mortgage assets had become a popular activity for many in the financial community. While a large proportion of these toxic assets were then offloaded to pensions and savings funds, some part of these assets were retained on the balance sheets of various banks.

Under fair-value accounting rules, these assets were to be periodically revalued, with any gains and losses recognized as a form of net income. Peddling the incredulous and unverifiable assumption that U.S. housing prices would consistently increase over the 30-year horizon of the underlying mortgages, several banks recognized fair-value gains on their subprime assets. Perversely, these paper gains, which fueled management compensation, drove the banks to originate still more subprime mortgages.¹⁴

While fair-value accounting didn't cause the 2008 Financial Crisis, it does seem to have had a catalytic effect on the conditions that brought us there.¹⁵

The period of the second rise of fair-value accounting, from the early 1990s through the 2008 Financial Crisis, coincides with the period that saw an aggressive financialization of the U.S. economy.¹⁶ For instance, between 1990 and 2006, the financial sector's share of the U.S. economy grew about 38%.¹⁷

One explanation for the growth of fair-value accounting is that as individuals from this sector became more influential in regulatory policy, they brought with them accounting procedures with which they were comfortable. Notably, fair-value accounting practices are widely used in asset management and investment banking for internal control purposes.¹⁸

Moreover, as implied earlier, fair-value accounting, when deployed to asset and liability classes without reliable or verifiable market prices, does provide opportunities to boost reported financial performance and executive compensation. Executives in firms with such assets and liabilities have incentives to lobby for fair-value accounting. And, indeed, in some cases, notably, accounting for purchased goodwill, they did.¹⁹

Given the checkered political history and record of fair-value accounting, its growing adoption in corporate reporting rules has left the accounting standards

¹⁴ See e.g. S. P. Kothari & Rebecca Lester, *The Role of Accounting in the Financial Crisis: Lessons for the Future*, 26 *Acc. Hor.* 335, 335–351 (2012).

¹⁵ See e.g. Christian Laux & Christian Leuz, *Did Fair-Value Accounting Contribute to the Financial Crisis?*, 24 *J. Econ. Persp.* 93, 93–118 (2010).

¹⁶ See e.g. Michael Power, *Fair value accounting, financial economics and the transformation of reliability*, 40 *Acc. & Bus. Res.* 197, 197–210 (2010).

¹⁷ Robin Greenwood & David Scharfstein, *The Growth of Finance*, 27 *J. Econ. Persp.* 3 (2013).

¹⁸ See e.g. Karthik Ramanna, *Political Standards: Corporate Interest, Ideology, and Leadership in the Shaping of Accounting Rules for the Market Economy* (2015).

¹⁹ *Id.*

boards with some explaining to do. Returning to the analogy of the school board, how could the use of a failing app be justified? How could the use of an accounting methodology that defies a basic understanding of reliable and verifiable performance metrics be legitimate?

The matter was made more awkward for the accounting boards by the fact that their own formal frameworks for evaluating good accounting practice listed “reliability” and “verifiability” as fundamental properties. I turn now to the story of how the accounting boards responded.

Corporate reporting rules for listed companies in the U.S. are largely determined by the Financial Accounting Standards Board (FASB). To guide its work, the FASB has developed a “conceptual framework,” a constitution-like document that sets out the fundamental principles of accounting.²⁰

The parts of the conceptual framework that are most relevant to this narrative are referred to in accounting parlance as CON 2 and were first codified in 1980. CON 2 focuses on the “qualitative characteristics” of accounting information and establishes “reliability” as one such “fundamental” property. Reliability is defined to include “verifiability” – the property that an accounting number can be objectively corroborated, rendering it less prone to bias and error.

Although “reliability” and “verifiability” were first codified by the FASB in 1980, these concepts have a longstanding basis in financial-reporting practice, being cornerstones of historic-cost accounting.²¹

In 2010, the FASB revised its conceptual framework to drop “reliability” as one of two fundamental qualitative characteristics of accounting (the other fundamental characteristic being “relevance”). The notion of reliability was replaced with that of “faithful representation.”

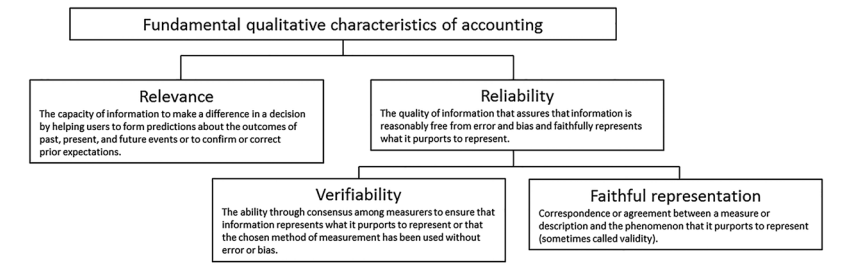
Moreover, the concept “verifiability,” which had been previously considered an element of reliability, was reclassified as an “enhancing” (as opposed to “necessary”) characteristic of accounting. (See Figure 2 for a summary of these changes and for brief definitions of the concepts.)

The changes were effected as part of a joint project with the International Accounting Standards Board (IASB) to harmonize the rules of these two accounting bodies. The IASB began operations in the early 2000s with the

20 See e.g. John M. Foster & L. Todd Johnson, *Why does the FASB have a Conceptual Framework?, Understanding the Issues—FASB* (2001). Note that unlike a legal constitution, the FASB Conceptual Framework does not have formal status in the hierarchy of accounting regulations.

21 See e.g. Yuji Ijiri & Robert K. Jaedicke, *Reliability and Objectivity of Accounting Measurements*, 41 *Acc. Rev.* 482, 474–483 (1966); Carsten Erb & Christoph Pelger, ‘Twisting words?’ A study of the construction and reconstruction of reliability in financial reporting standard-setting, 40 *Acc., Orgs. & Soc.* 13, 13–40 (2015).

Original conceptual framework, CON 2, 1980



Revised conceptual framework, CON 8, 2010

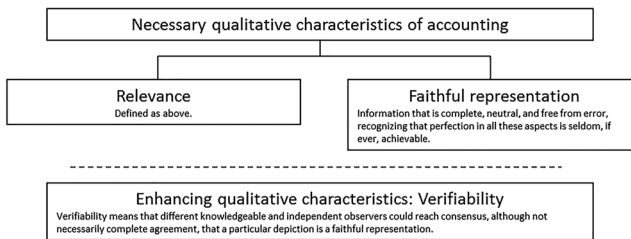


Figure 2: Some key differences between the FASB's original and revised conceptual frameworks.

ambition to set accounting rules for much of the world outside the US. The IASB's conceptual framework was itself quite similar (although not identical) to that of the FASB's, having been inspired partially by the U.S. version.²²

In outlining its basis for these changes, the FASB, in its official record, argued that its original intent had always been for reliability to be understood as “faithful representation” – a phrase it defined somewhat circularly as an accounting estimate that “represent[s] what it purports to represent.” In justifying the change, the FASB maintained that the term reliability had come to be misunderstood in practice to mean, among other things, measurement precision.²³ In this sense, the FASB argued that the shift away from reliability simply clarified the conceptual framework.

Some prominent observers of the change, including one former member of the IASB, argued that the change was more significant than a clarification of original intent.²⁴ They argued that the change was partly driven by the need to reconcile the FASB and IASB conceptual frameworks with the growing use of fair-value

²² See e.g. Kees Camfferman & Stephen A. Zeff, *Aiming for Global Accounting Standards: The International Accounting Standards Board, 2001–2011* (2015).

²³ Conceptual Framework: Statement of Financial Accounting Concepts No. 8, Financial Accounting Standards Board (FASB) (2010), at 16, 26–27.

²⁴ See e.g. Geoffrey Whittington, *Fair Value and the IASB/FASB Conceptual Framework Project: An Alternative View*, 44 ABACUS 139, 139–168 (2008); Camfferman & Zeff, *Aiming for Global*.

accounting. Because fair values could not always be reliably measured, the notions of reliability and verifiability in CON 2 posed a serious intellectual impediment to the growing use of fair-value accounting in GAAP.

In this manuscript, I principally examine these two explanations for the changes to the FASB and IASB conceptual frameworks. I draw on primary archival evidence from FASB and IASB board meeting minutes, internal and external staff documents, and communication by key FASB constituents. I also rely on original field interviews with 13 board members, seven senior staffers, and seven active constituents of the FASB and IASB at the time. Finally, I supplement these sources with secondary data from academic and media articles on the changes.

The evidence does not entirely rule out either explanation. A small core group of senior staff members at the FASB, in particular, had long held the view that the term reliability was misinterpreted in practice. To these FASB insiders, the revisions to the conceptual framework did in fact represent a clarification of original intent.

But to several board members and constituents, the revisions reflected a need to update the framework to be consistent with changes in the nature of GAAP, especially fair-value accounting. As one individual who served as a board member during the deliberations noted, “The major thing hanging over our head then was fair-value measurement... This issue of reliability versus faithful representation was very core to the decisions in fair-value measurement... No one came out and said that, but it was pretty clear that this was one of the big things... Fair value was used in thirty-plus places in the accounting literature... I might not have known it in the beginning [when I joined the board], but in the end it was pretty clear.”²⁵

The evidence consistent with this latter explanation is noteworthy for at least two reasons. First, it suggests that the FASB’s own official explanation for the changes to the conceptual framework is at best incomplete.²⁶ This official explanation is part of the GAAP record that constituents and even regulators themselves refer to as they attempt to interpret accounting rules. Selective reporting in this record risks compromising trust in the FASB’s internal practices and procedures.

Second, and perhaps more significantly, it illustrates the importance to regulators of having a conceptual narrative for their actions, even if such a narrative is constructed *ex post facto*. After all, the changes to the conceptual framework were effected in 2010, nearly 20 years after the FASB first initiated a major thrust towards fair-value accounting. (See Figure 1.)

It is possible that regulators construct conceptual narratives for their actions because they crave an internal intellectual consistency. But, as I expand later, manufacturing and adopting a new conceptual narrative is costly, in terms of both

²⁵ Interview with Subject No. 11, August 2015.

²⁶ For citations to primary sources on this official explanation, please see Section 3.2.

direct and opportunity costs. Moreover, the conceptual framework was created to *guide* standard setting, but the evidence herein suggests it was being modified to reflect *changes in* standard setting, a circularity that is both publicly observable and socially costly. This observation suggests that there is likely a stronger reason for the conceptual-framework revisions than seeking internal consistency.

A more plausible explanation is that conceptual narratives provide regulators cover against criticism. To this end, the timing of the superseding of reliability and verifiability in CON 2 can be informative. While the project was first seriously conceived in 2004, the FASB and IASB boards cast their final effective votes on the changes in January 2009, at the very height of the global financial crisis, when stock markets had sunk to dangerous lows and their regular working was disrupted.

Accounting rulemaking, albeit critical to the economy, is usually an obscure and esoteric activity. The “thinness” of political participation in this process enables capture of GAAP by informed special interests.²⁷ But even thinly attended processes occasionally draw public attention. And it is difficult to imagine a time other than the recent global financial crisis when media scrutiny on accounting rules was higher.

So, as the world was reeling from a financial crisis, the boards that oversaw accounting rulemaking for much of the global economy voted to eliminate “reliability” and “verifiability” as necessary properties in corporate financial reporting. This, they did in part, to deflect criticisms about the dangers of fair-value accounting, criticisms that had started to become more audible to the general public due to the global financial crisis.

In this sense, the revisions are an illustration of a phenomenon I describe as *conceptual veiling*, wherein regulators fabricate or embrace conceptual justifications for their actions in an attempt to diffuse criticisms.

Conceptual veiling is costly to regulators not only because producing conceptual narratives is time consuming but also because embracing a given conceptual justification usually involves taking sides in an ideological debate. This approach can lower public perception of regulatory neutrality.²⁸

For instance, there has been a longstanding debate in the accounting community, dating back a century at least, between the merits of “relevant” versus “reliable” accounting.²⁹ CON 2’s position, to represent GAAP as existing in a permanent tension between these two forces can be seen as an effort to play both sides and thus stay neutral. By purging “reliability” from the conceptual framework, the FASB has made a costly decision to move away from that perceived regulatory neutrality.

²⁷ See Ramanna, Political Standards.

²⁸ See James Kwak, Cultural Capture and the Financial Crisis in Preventing Regulatory Capture, 72–98 (2014, eds. Daniel Carpenter and David A. Moss).

²⁹ See Paton & Littleton.

Given these costs, the benefits to regulators from conceptual veiling must be substantial enough to justify the tactic. Put differently, the criticisms that the regulators hope to diffuse through the veiling must constitute a sufficiently serious threat.

Key amongst these criticisms in the case of the FASB's revisions to its conceptual framework is the suspicion that the increased use of fair value measurements is due to the influence of certain special interests seeking to manipulate financials for their own private benefit.

Note that it is not necessary for the regulator to be actually captured; just the perception of capture is sufficient to precipitate the changed conceptual justifications. For instance, while there is circumstantial evidence linking the rise of fair-value accounting to certain special interests from the financial sector, the evidence for capture is rarely dispositive.³⁰

With the changes to the conceptual framework now in place, objections to fair values on conceptual grounds, such as their insubstantial reliability, will be less persuasive in standard-setting deliberations. The conceptual framework changes may then bolster still more fair values in GAAP. This conclusion, if true, is concerning in light of the role of fair values in prior accounting scandals such as Enron and financial crises such as those of 1929 and 2008.³¹

The conceptual-framework changes described in this paper are very likely not the first instance of the FASB engaging in conceptual veiling, at least in the narrow sense of expropriating conceptual terms to diffuse criticism of their own actions. For instance, accounting theorist Shyam Sunder has observed that the use of the term *fair value* to describe the current exit valuation of an asset or liability is itself a rhetorical game of “using clever labels to put the opponents of your proposal on the defensive before the debate even starts. Who would want to defend the use of ‘unfair’ values in accounting?”³² Another potential example of conceptual veiling is the FASB's appropriation of the term “GAAP” to describe its standard setting activities: previously, GAAP had referred to common-sense accounting best-practice that emerged from trial-and-error in the field, not rules delivered by code from above.

The notion of conceptual veiling developed herein can be useful in understanding regulatory behavior in contexts beyond accounting, for instance, bank-

30 See e.g. Abigail M. Allen & Karthik Ramanna, Towards an Understanding of the Role of Standard Setters in Standard Setting, 55 J. Acc. & Econ. 66, 66–90 (2013).

31 It bears noting that as of 2018, the IASB, but not the FASB, appears to be backtracking on some of the conceptual framework changes: for instance, by emphasizing the importance of “measurement uncertainty” in accounting, as a possible successor to “reliability.” These developments are as yet ongoing, so their real impact, if any, remains unclear. See e.g. Christoph Pelger, The comeback of stewardship, reliability and prudence? – An analysis of the IASB's new conceptual framework (2018).

32 See Shyam Sunder, Econometrics of Fair Values, 22 Acc. Hor. 112, 111–125 (2008).

governance regulation. Here, some regulators have framed the 2008 banking crises as being due to insufficient market liquidity rather than bank insolvency. This conceptual framing justified bailouts and other forms of regulatory forbearance, such as treating “deferred tax assets” as an element of prime-quality bank capital. Concerns that such regulatory indulgences are due to capture by the banks are diffused by the regulators embracing elegant theories relating banking crises to (temporary) market illiquidity.³³

* * *

The remainder of the manuscript is organized as follows. Section 2 provides background material: first, an overview of the accounting rulemaking establishment and the FASB’s conceptual framework (which can be skipped by those in the know); then, a discussion of related prior literature. Section 3 outlines various plausible explanations for the changes to reliability and verifiability in the conceptual framework.

Section 4 provides a historical description of the events leading up to the relevant changes in the conceptual framework. This section draws on primary sources at the FASB and IASB, including board meeting minutes and staff documents. Section 5 introduces evidence from the original field interviews with key players to help examine the various possible explanations for the removal of reliability from the FASB’s conceptual framework.

In Section 6, I interpret the evidence from the previous two sections in the context of the hypotheses in Section 3. Here, I also further develop the proposition of conceptual veiling and conclude with implications for regulation in accounting and beyond.

2 Background

2.1 Overview of the Institutions of GAAP

In the Securities Exchange Act of 1934, Congress vested in the Securities and Exchange Commission (SEC) the authority to determine the standards under which listed corporations in the U.S. have to report financial information.³⁴ The SEC has,

³³ See e.g. Anat R. Admati & Martin F. Hellwig, *The Bankers’ New Clothes: What’s Wrong with Banking and What to Do About It* (2014); further, two issues in this journal speak to the matter: Vol 3, Issue 3 (Oct 2013) *Banking, Finance, and the Minsky’s Financial Instability Hypothesis*, and Vol 8, Issue 2 (Jul 2018) *The Money Problem. Perspectives on Money, Banking and Financial Regulation*.

³⁴ See §13 (b), Pub. L. No. 73–291, 48 Stat. 881.

since the late 1930s, effectively deferred that authority to private organizations. At first, the authority to organize and determine accounting principles was held by the Committee on Accounting Procedures (CAP) of the American Institute of Certified Public Accountants (AICPA, known from 1917 to 1957 as the American Institute of Accountants). The CAP held sway through 1959 when it was replaced by another AICPA organ, the Accounting Principles Board (APB).³⁵

Both the CAP and the APB represented attempts at self-regulation – the accounting profession determined accounting standards through its primary membership organization, the AICPA. Indeed, members of the CAP and the APB served part time, often holding fulltime senior positions at leading audit firms. Moreover, these audit firms directly supported the research activities of their standard setters.³⁶ Largely due to concerns about the lack of independence in accounting rulemaking, and in the face of some particularly political decisions by the APB, this organization was replaced by the FASB in 1973.³⁷ Since then, the *de facto* authority to determine U.S. GAAP has vested in the FASB.

The FASB is part of a private not-for-profit organization, the Financial Accounting Foundation (FAF). The trustees of the FAF are responsible for selecting the members of the FASB, who in turn vote on GAAP standards. In practice, this selection has input from the SEC – the commissioners and, especially, the SEC chief accountant. Until the passage of the Sarbanes-Oxley Act in 2002, the FAF was also responsible for raising funds for the operation of the FASB, including salaries for FASB members. In principle, the FAF's fundraising activities were separate from the FASB's rulemaking activities, to avoid any appearance of impropriety. Since the passage of the Sarbanes Oxley Act, the FASB has been funded by a nominal "tax" on listed corporations in the United States.³⁸

The FASB differs from its predecessor body, the APB, in at least three important ways. First, members of the FASB serve fulltime. They must resign all existing commitments prior to taking up their seats on the board. They are also generously compensated, at least by the standards of public regulators at the SEC – estimated to be earning in excess of half-a-million dollars annually in 2015. Second, FASB members are supported by an independent fulltime professional staff that conduct research, provide technical guidance, and manage projects for board members. The staff is often quite influential in the nature of FASB activities. The APB, as

³⁵ See The Richard C. Adkerson Gallery on the SEC Role in Accounting Standards Setting, Securities and Exchange Commission Historical Society (SECHS) (2013), <http://sechistorical.org/museum/galleries/rca/> (last visited Sept. 2013).

³⁶ *Id.*

³⁷ See e.g. Stephen A. Zeff, The Evolution of U.S. GAAP: The Political Forces behind Professional Standards Part 1: 1930–1973, 75 CPA J. 18, 18–27 (2005).

³⁸ See §109, Pub. L. No. 107–204, 116 Stat. 745.

noted earlier, relied in some measure on research input from the audit firms.³⁹ Third, the FASB is independent of the AICPA. In this sense, it is not an organ of the accounting profession.⁴⁰ In addition to audit firms, members of the FASB are drawn from financial and industrial firms.⁴¹

The FASB is formally advised by an organization called the Financial Accounting Standards Advisory Council (FASAC). Membership in the FASAC is drawn from various constituents including corporate controllers and treasurers, auditors, investment managers, financial analysts, and academics. The FASAC provides input to the FASB on its agenda and its draft standards. These drafts, prepared by the FASB staff, take two forms – a discussion memorandum (DM), which is usually a preliminary document, and an exposure draft (ED), which is usually closely resembles a final standard. The FASAC advice is not binding. Beyond the FASAC, the FASB encourages its constituents to directly comment on DMs and EDs. At times, as the FASB drafts the language of its proposed standards, it holds public hearings or hosts board meetings with select constituents, particularly those with deep subject-matter expertise.

About one-third of publicly traded corporations in the world (by sales) use accounting rules developed by the FASB. About 50% of publicly traded corporations (by sales) use some form of International Financial Reporting Standards (IFRS). The degree to which firms use IFRS varies considerably across jurisdictions, as some jurisdictions such as Canada are more committed to a strict adherence to IFRS than others such as China. Local political and economic incentives in jurisdictions that have at least nominally adopted IFRS explain much variation in IFRS adoption in practice.⁴²

IFRS is the result of an ambitious program to harmonize accounting rules across the world that has its roots at least in the 1970s, in an organization called the International Accounting Standards Committee. This organization developed International Accounting Standards that influenced and were influenced by accounting rules in several countries including Australia, Canada, the U.K., and

39 The APB did in fact have a fulltime research staff, but in practice the part-time audit partners who served on the board often had research backup from their respective firms. See Stephen A. Zeff, *The Wheat Study on Establishment of Accounting Principles (1971–72): A historical study*, 34 *J. Acc. and Pub. Pol.* 146–74 (2015).

40 From 1973 to 1977 the AICPA had indirect control over the FASB, as most FAF trustees were appointed by the AICPA board of directors. Since 1977, the FAF and FASB have enjoyed greater autonomy from the AICPA. See Zeff, *The Wheat Study*.

41 See Allen & Ramanna for summary statistics on backgrounds of FASB members during its first thirty-five years.

42 See e.g. Karthik Ramanna, *The International Politics of IFRS Harmonization*, 3 *Acc., Econ. & Law* 1, 1–46 (2013).

the United States. International harmonization of accounting rules got a major boost in 2001 when the IASC was replaced by the IASB. A key factor in the establishment of the IASB was the European Commission's recommendation in 2000 to require IFRS for all listed companies in the European Union by 2005.⁴³

From the beginning, the United States has been a key player in the IASB. The implicit assumption among many early leaders at the IASB – both American and non-American – was that the United States would eventually adopt IFRS as well. In fact, the IASB was organized in a structure quite similar to that of the FASB, ostensibly to mitigate any concerns about the board's governance structure.⁴⁴ Mirroring the relation between the FASB and the FAF, the IASB is formally part of the IFRS Foundation, whose trustees are charged with appointing IASB members. The IFRS Foundation is responsible for raising funds for the IASB's operations, just as the FAF did prior to the Sarbanes-Oxley Act's passage. Also, the IASB is advised at least partially by the IFRS Advisory Council, which is analogous to the FASAC.

At the time of the changes to the FASB and IASB conceptual frameworks, which are the subject of this manuscript, convergence efforts between these boards were arguably at their zenith. There was a keen interest among board members and staff to eliminate substantive differences between U.S. GAAP and IFRS. Indeed, several employees at the IASB were ex-FASB. The financial crisis of 2008–09 and its aftermath put a damper on FASB-IASB convergence. In fact, the changes described in this manuscript are amongst the last to have been effected before convergence momentum slowed. In 2012, the SEC issued a staff paper that effectively delayed indefinitely any attempt at permanently harmonizing U.S. GAAP with IFRS.⁴⁵

2.2 Overview of the Conceptual Framework

When the APB was first constituted in the 1950s to replace the CAP, the AICPA recommended that it adopt a set of conceptual principles for its standard-setting activities. The CAP's demise had been at least partly attributed to the ad hoc and political nature of its rulemaking, and the AICPA was keen to avoid this failure

⁴³ See e.g. Kees Camfferman & Stephen A. Zeff, *Financial Reporting and Global Capital Markets: A History of the International Accounting Standards Committee, 1973–2000* (2007); further, an issue in this journal speaks to the matter: Vol 7, Issue 2 (Jul 2017) Which Accounting Regulation for Europe's Economy and Society.

⁴⁴ Id.

⁴⁵ See Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Final Staff Report, Securities and Exchange Commission (SEC) (2012), <http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf> (last visited November 2013).

again.⁴⁶ The fledgling APB did in fact commission a set of research studies that it hoped would provide the basis for a conceptual framework, but the board did not formally adopt the studies partly because they departed from prevailing accounting practice in many ways.⁴⁷

Another attempt at a conceptual framework for the APB in the 1960s, again at the behest of the AICPA, resulted in a non-binding publication in 1970 – APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* – but the APB itself did not last much longer. As noted earlier, it suffered a similar fate as its predecessor, the CAP, for some of the same reasons. A former APB member and Stanford professor Charles Horngren noted, “My experience as a member of the APB taught me many lessons. A major one was that most of us have a natural tendency and an incredible talent for processing new facts in such a way that our prior conclusions remain intact”.⁴⁸

Not surprisingly then, when the FASB was constituted in the early 1970s, one of its first priorities was to put together a conceptual framework for standard setting. In fact, the Trueblood Study Group of the AICPA (1971–73), which was constituted in response to a crisis of confidence in the APB – a crisis that eventually led to the APB being supplanted by the FASB, had already sketched an outline for a conceptual framework for accounting.⁴⁹

In the words of two longtime FASB insiders John Foster and Todd Johnson, a conceptual framework at the FASB was expected to “reduce political pressures in making accounting judgments” and also reduce “the influence of personal biases on standard-setting decisions.” They noted, “In an environment in which standard setting is based on the personal conceptual frameworks of individual standard setters, agreement on specific standard-setting issues will only occur when a sufficient number of those personal frameworks intersect. However, even those agreements may prove to be transitory because, as the membership of the body changes over time, the mix of individual conceptual frameworks will change as well. As a result, that standard-setting body may reach significantly different conclusions about similar—or even identical—issues than it did earlier, resulting in standards not being consistent with one another and past decisions not being indicative of future ones. Standard setting therefore becomes more or less ad hoc. Moreover, without a framework, rational debate cannot occur because positions

⁴⁶ See e.g. Zeff, *The Evolution of U.S. GAAP*.

⁴⁷ Foster & Johnson, *Why does the FASB*. Notably, the final such study in 1962 was seen as “too radical” for its embrace of what we have come to see today as fair-value accounting.

⁴⁸ *Id.* at 2.

⁴⁹ Stephen A. Zeff, *The Trueblood Study Group on the Objectives of Financial Statements (1971–73): A historical study*, 35 *Journal of Acc. and Pub. Pol.* 134 (2016).

about the appropriate accounting treatment for a given transaction can neither be defended nor refuted—the appropriate treatment is simply ‘in the eye of the beholder.’ That was the case with the AICPA’s Committee on Accounting Procedure which preceded the Accounting Principles Board (APB) and, it largely was true of the APB as well”.⁵⁰

The first official FASB document on its conceptual framework was published in 1978, five years after the FASB began operations. Titled CON 1, Objectives of Financial Reporting by Business Enterprises, the document’s most significant position was to establish financial reporting’s objective as “decision usefulness” for “investors and creditors.” This was the position of the Trueblood Study Group that had had a formative influence on the early FASB. Notably, its namesake and primary driver, Robert Trueblood, had argued “that the definition of financial accounting must go beyond its historic confines and embrace ‘the measurement and communication of all economic and quantitative data.’”⁵¹

While this objective might have seemed innocuous, it did mark a significant departure from the long-held tradition that holding management accountable for its “stewardship” of corporate resources was the key objective of financial reporting. The spirit of CON 1 was that decision usefulness could include stewardship, but not to the exclusion of investors’ valuation demands. CON 1 thus laid a conceptual foundation for current-value estimates in financial statements.

As the first of the FASB conceptual framework documents, CON 1 also laid out the aims for this project: “The purpose of the series is to set forth fundamentals on which financial accounting and reporting standards will be based... The Board itself is likely to be the major user and thus the most direct beneficiary of the guidance provided by the new series. However, knowledge of the objectives and concepts the Board uses should enable all who are affected by or interested in financial accounting standards to better understand the content and limitations of information provided by financial accounting and reporting, thereby furthering their ability to use that information effectively and enhancing confidence in financial accounting and reporting.”⁵²

CON 1 also made clear that the conceptual framework documents would not hold the official status of GAAP standards. While this was a “constitution” for GAAP, intended to insulate GAAP from idiosyncrasies and politics, it would be an advisory constitution.

The second, and perhaps most significant conceptual framework document until 2010, was CON 2, Qualitative Characteristics of Accounting Information,

⁵⁰ Foster & Johnson, Why does the FASB, at 2.

⁵¹ Zeff, The Trueblood Study Group, at 138.

⁵² Statement of Financial Accounting Concepts No. 1, Financial Accounting Standards Board (FASB) (1978), 6.

issued in 1980. As the title suggests, this document established the principles to guide recognition and measurement criteria in financial statements. The document arose in the context of “fierce” debates in the 1970s among accountants about how to account for inflation, in particular, whether and when current-value adjustments were meaningful in financial reporting. The debates were not resolved, and CON 2 effectively codified principles that reflected existing practice.⁵³

Arguably the primary accomplishment of CON 2 was to recognize that accrual estimates represented balancing considerations of “relevance” and “reliability.” While these two principles, which were both recognized as “fundamental,” did not always conflict with each other, they often did, and CON 2 set out for FASB standards to reflect this balance. Reliability in CON 2 was defined to include “verifiability,” “faithful representation,” and “neutrality.” Besides these principles, CON 2 also recognized the importance of “comparability” of financial statements across firms and industries and “consistency” across time.

CON 2 defined verifiability as a quality “that may be demonstrated by securing a high degree of consensus among independent measurers using the same measurement methods”.⁵⁴ Neutrality – defined as a “freedom from bias” – stood in contrast to the longstanding accounting principle of “conservatism,” which in turn called for a higher standard for recognizing gains versus losses. CON 2 recognized “a place for a convention such as conservatism” in GAAP, but somewhat reluctantly so.⁵⁵ Several observers have noted that CON 2 had at least the subtle flavor of endorsing balance-sheet primacy over an income-statement view to determining GAAP.⁵⁶

Beyond CON 2, two other FASB conceptual framework documents are relevant to the changes in the 2000s that effected the purge of “reliability.” (See Table 1 for a list of FASB documents relevant to the conceptual framework changes on reliability and verifiability.) The first is CON 5, issued in 1984, and which dealt with Recognition and Measurement in Financial Statements of Business Enterprises.

⁵³ See Whittington, at 141. For contemporaneous academic critiques of CON 1 and CON 2, see e.g. Nicholas Dopuch & Shyam Sunder, FASB’s Statements on Objectives and Elements of Financial Accounting: A Review, 55 *Acc. Rev.*, 1–22 (1980); Edward J. Joyce, Robert Libby & Shyam Sunder, Using the FASB’s Qualitative Characteristics in Accounting Policy Choices, 20 *J. Acc. Res.*, 654–675 (1982).

⁵⁴ Statement of Financial Accounting Concepts No. 2, Financial Accounting Standards Board (FASB) (1980), 6.

⁵⁵ *Id.* at 35.

⁵⁶ Under balance-sheet primacy, the income statement for a period simply reports the changes between the beginning-of-period and end-of-period balance sheet elements. Under the income-statement view, this latter document is prepared independently—drawing upon general principles of accounting—and then reconciled with the balance sheet, using a statement of comprehensive income. See e.g. Ilia D. Dichev, On the Balance Sheet-Based Model of Financial Reporting, 22 *Acc. Hor.* 453, 453–470 (2008).

Table 1: FASB documents relevant to the conceptual framework changes on reliability and verifiability.

Name	Date issued	Subject
CON 1	November 1978	Title: "Objectives of Financial Reporting by Business Enterprises" Establishes "decision usefulness" as the primary objective
CON 2	May 1980	Title: "Qualitative Characteristics of Accounting Information" Establishes "relevance" and "reliability" as "fundamental" – where reliability includes "representational faithfulness" and "verifiability"
CON 5	December 1984	Title: "Recognition and Measurement in Financial Statements of Business Enterprises" Establishes reliability as one of four conditions for recognizing an item on the financial statements
CON 7	February 2000	Title: "Using Cash Flow Information and Present Value in Accounting Measurements" Provides a framework for using future-cash-flow estimates in accounting; suggests reliability is a key consideration
DM	July 2006	Title: "Conceptual Framework for Financial Reporting" Proposes replacing reliability with "faithful representation"; verifiability is included in the definition of faithful representation
ED	May 2008	Title: "Conceptual Framework for Financial Reporting" Proposes removing verifiability from the definition of faithful representation; proposes reclassifying verifiability as an "enhancing" (rather than a "necessary") characteristic of accounting
CON 8	September 2010	Title: "Conceptual Framework for Financial Reporting" Replaces reliability with faithful representation; removes verifiability from the definition of faithful representation; reclassifies verifiability as an enhancing (rather than a necessary) characteristic of accounting

The second is CON 7, issued in 2000, and which dealt with Using Cash Flow Information and Present Value in Accounting Measurements.

In CON 5, "reliability" was tightly connected with the principles for financial statement recognition. In fact, it was established as one of four conditions for such recognition (the other three being measurability, relevance, and that the item in question met the definition of a financial statement element). CON 5 noted: "Although recognition involves considerations of relevance and comparability, recognition criteria, conventions, and rules are primarily intended to increase reliability—they are means of coping with the uncertainty that surrounds business and economic activities. Uncertainty in business and economic affairs is a continuum, ranging from mere lack of absolute sureness to a degree of vagueness that precludes anything other than guesswork. Since uncertainty surrounds an entity's incomplete cash-to-cash cycles in varying degrees, measuring progress reliably involves determining whether uncertainty about future cash flows has been

reduced to an acceptable level”.⁵⁷ To reinforce the centrality of reliability, CON 5 added: “Information about some items that meet a definition [of an element of financial statements] may never become sufficiently reliable at a justifiable cost to recognize the item.”⁵⁸

Despite its scope and its extensive coverage of recognition principles, CON 5 gave “virtually no guidance” on measurement principles.⁵⁹ This necessitated the issuance of CON 7, which when published in 2000 was the first FASB conceptual framework document in 15 years. On the question of current-value estimates, CON 5 had stated (p. 32) that information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information. CON 7 went beyond this terse language, recognizing that by the time the FASB had been regularly issuing fair-value-based GAAP standards for about a decade. CON 7 provided “a framework for using future cash flows as the basis for accounting measurements at initial recognition or fresh-start measurements”.⁶⁰

But even CON 7, with its emphasis on legitimizing current-value estimates, recognized the centrality of reliability established in CON 2: “The accounting problem is to balance the cost of obtaining additional information against the additional reliability that information will bring to the measurement.”⁶¹

The final FASB conceptual framework document I consider in this manuscript is referred to as CON 8. This is the document that replaced both CON 1 and CON 2 when issued in 2010. Most importantly for the subject of this manuscript, CON 8 eliminated reliability as a “fundamental qualitative characteristic” of accounting and reclassified verifiability from being a “necessary” to being an “enhancing” property of financial reporting.

As already noted, CON 8 was issued as a joint project with the IASB, in an effort to expand convergence between IFRS and U.S. GAAP. The IASB had not developed its extant conceptual framework; it had inherited it from its predecessor body, the IASC. That framework, which was published in 1989, was largely inspired by the FASB’s. Camfferman and Zeff note that the similarities were due to the IASC’s desire to improve its standing with the International Organization of Securities

⁵⁷ Statement of Financial Accounting Concepts No. 5, Financial Accounting Standards Board (FASB) (1984), 22.

⁵⁸ *Id.* at 28.

⁵⁹ R. J. Swieringa, Robert T. Sprouse and Fundamental Concepts of Financial Accounting, 25 *Acc. Hor.* 216 (2011).

⁶⁰ Statement of Financial Accounting Concepts No. 7, Financial Accounting Standards Board (FASB) (2000), 4.

⁶¹ *Id.* at 22.

Commissions, of which the SEC was an important member.⁶² In fact, beyond inspiring the IASC's conceptual framework, the FASB's conceptual framework had prompted similar such initiatives in Australia, Canada, New Zealand, and the U.K. by 1999.⁶³

Besides being a terser version of the FASB framework, the IASB framework differed in two important ways. First, it did not explicitly mention "verifiability," although the principle was obliquely referred to in the framework's definition of reliability. Second, it afforded a warmer reception to the longstanding accounting principle of conservatism, which, in keeping with English traditions, it referred to as "prudence." English accounting principles had evolved closely with company law, and in this interplay between law and accounting the notion of conservative accrual estimates helped limit liability for overstatement of unrealized gains.⁶⁴

Given that it had inherited its conceptual framework from the IASC, Camfferman and Zeff report that the IASB was from its inception keen to revisit the framework.⁶⁵ But, the newly formed board, perhaps recognizing the magnitude of this challenge, did not want to "comprehensively reconsider all components of the framework in the pyramid, but rather [focus] principally on those issues that are more likely to yield standard-setting benefits in the near term."⁶⁶ These were defined as "troublesome conceptual issues that reappear time and time again in different standard-setting projects and in a variety of different guises". Ostensibly, the notion of accounting reliability was one such troublesome issue.⁶⁷

2.3 Related Literature

In terms of prior literature, this study is most closely related to that of Erb and Pelger.⁶⁸ In providing a comprehensive history of the evolution of "reliability" in accounting rulemaking, Erb and Pelger discuss the process culminating in the 2010 FASB-IASB revisions to their respective conceptual frameworks.

But there are significant distinctions between the two studies as well. First, whereas Erb and Pelger rely on interviews with seven IASB protagonists, this study draws from 27 interviews with both FASB and IASB players. Further, only three

⁶² Camfferman & Zeff, *Aiming for Global*, at 358–359.

⁶³ See e.g. Foster & Johnson.

⁶⁴ Camfferman & Zeff, *Aiming for Global*, at 364.

⁶⁵ *Id.*, at 359.

⁶⁶ *Id.*

⁶⁷ L. Todd Johnson, *The Project to Revise the Conceptual Framework*, FASB Report (2004), at 3.

⁶⁸ See generally Erb & Pelger.

interviewees overlap across the two studies, suggesting the data herein substantially expand on Erb and Pelger's analysis.

Moreover, whereas Erb and Pelger are focused on the history of regulators' efforts to change the meaning of accounting reliability, this manuscript is a study of the causes and political implications of eliminating reliability from the conceptual framework. A key innovation of this study is the development of the notion of conceptual veiling.

More broadly, this manuscript builds on the economics-based literature on the nature of regulation, particularly capture and responses to capture, described in Stigler, Peltzman, Kalt and Zupan, Kwak, and Zingales, amongst others; Dal Bo provides a review.⁶⁹ This manuscript's connections to the regulation literature are explored in Section 6.

Also related to this study are the works of Power, who examines the impact of the financialization of the economy on accounting rules; Pelger, who investigates the FASB conceptual-frameworks' emphasis on valuation usefulness; and Young, who makes the case for the importance to the FASB of conceptual rhetoric in everyday rulemaking.⁷⁰ These are each discussed in other parts of this manuscript, where they are directly relevant.

3 Some Plausible Hypotheses to Explain the Elimination of "Reliability"

3.1 The Rise of Fair-Value Accounting

By the time the FASB began reconsidering the role of reliability in its conceptual framework in 2004, that framework had been in place for 24 years. That time period, however, had witnessed a significant shift in the nature of accounting, from a largely historical-cost basis to a mixed basis utilizing both historical values and fair-value estimates.

69 See generally George J. Stigler, *The Theory of Economic Regulation*, Bell J. Econ. & Mgmt. Sc. 3, 3–21 (1971); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J. Law & Econ. 211, 211–240 (1976); Joseph P. Kalt & Mark A. Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 Amer. Econ. Rev. 279, 279–300 (1984); Kwak; Luigi Zingales, *Preventing Economists' Capture in Preventing Regulatory Capture*, 124–151 (2014, eds. Daniel Carpenter & David A. Moss); Ernesto Dal Bo, *Regulatory Capture: A Review*, 22 Oxf. Rev. of Econ. Pol. 203, 203–225 (2006).

70 See generally Power; Christoph Pelger, *Practices of Standard-Setting: An Analysis of the IASB's and FASB's Process of Identifying the Objective of Financial Reporting*, 50 Acc., Org. & Soc. 51, 51–73 (2016); Joni J. Young, *Constructing, Persuading and Silencing: The Rhetoric of Accounting Standards*, 28 Acc., Org. & Soc. 621, 621–38 (2003).

Allen and Ramanna report that the proportion of FASB standards with fair-value measures increased in the 1990s.⁷¹ While the period from the FASB's initiation of operations in 1973 through 1990 witnessed some fair-value based standards in GAAP, the period from 1990 through 2007 represented the relative heyday for fair-value accounting. (See Figure 1.)

There are several hypotheses for the increasing recourse to fair-value accounting. Zeff argues that the unleashing of fair values in GAAP can be attributed to one key individual, Richard Breeden, who in 1989 was appointed chairman of the SEC.⁷² Breeden's appointment came at the time of the savings-and-loan crisis in the United States, where a number of financial institutions were found to have obfuscated their precarious financial position by misusing historical-cost accounts to represent effectively insolvent long-term assets. The marking of these assets to market, it was argued, could have mitigated the crisis by alerting investors to the situation in a timelier fashion.

In 1992, Breeden appointed Walter Schuetze as the SEC's chief accountant. Schuetze was sympathetic to the arguments on fair-value accounting, in a stark break from the tradition at the SEC.⁷³ The commission had been established in the shadow of the stock-market crash of 1929, where the unverifiable use of fair values had been assigned some of the blame for the market run-up in the 1920s. Since then, the SEC had taken a hardline approach to fair-value accounting, effectively banning its use in GAAP with very few exceptions.⁷⁴ But Schuetze was not attached to the SEC's anti-fair-value position, and, moreover, the savings-and-loan crisis provided a context where marking-to-market would have been ostensibly prudent.

While the appointments of Breeden and Schuetze and the savings-and-loan crisis were the plausible sparks that lit the fair-value fire, the subsequent growth of fair-value accounting can be attributed to the increasing financialization of the economy in the 1990s.⁷⁵

Greenwood and Scharfstein report that in the early 1970s, when the FASB got started, the financial-services sector represented about 4 percent of U.S. gross domestic product (GDP); by 1990, that sector represented about 6 percent of GDP; and by 2006 it accounted for 8.3 percent of GDP.⁷⁶ The growth of derivatives, options-based compensation, and the increased use of hedging by even non-

⁷¹ See Allen & Ramanna.

⁷² See Stephen A. Zeff, *The SEC Suppresses Fair Value – Until the 1990s* (2015).

⁷³ See *id.*

⁷⁴ See Zeff, *The SEC Rules Historical Cost Accounting*.

⁷⁵ See e.g. Power.

⁷⁶ See Greenwood & Scharfstein; further, an issue in this journal speaks to the power of the financial industry over society: Vol 6, Issue 1 (March 2016) *The Power of Inaction. Bank Bailouts in Comparison*.

financial corporations created a demand for more fair-value based estimates in financial statements. Moreover, as the financial markets underlying derivatives became more developed, the prices in these markets started to look more reliable, further justifying the use of fair values in GAAP.⁷⁷

Allen and Ramanna associate the rising proportion of FASB standards using fair-value measures to the increasing proportion of FASB board members from the asset management and investment banking sectors.⁷⁸ It is difficult to say conclusively why these sectors enjoyed greater representation on the FASB, but one plausible explanation is the increased prestige associated with these industries that accompanied that financialization of the economy in the 1990s. For instance, Khurana has argued that the stature of those employed in the financial sector grew through the 1990s and beyond, as that sector became more central to economic activity.⁷⁹ Relatedly, Power has argued that the rising social status of financial economics has shifted the focus of accounting over time from managerial stewardship of corporate resources, where reliability would be important, to investor valuation of the firm, where fair-value accounting is emphasized.⁸⁰

In the asset management and investment banking sectors, fair-value accounting has long been employed for internal-control purposes. In both sectors, firms prepare daily balance sheets at current values to estimate their outstanding assets and liabilities. As these sectors came to enjoy increased influence at the FASB, they likely advocated for the expanded use of fair values throughout GAAP.⁸¹ Such advocacy can be attributed to their own conceptual familiarity with fair values – their ideological predisposition to a current-value basis for accounting.

But it can also be attributed to their economic incentives. Both investment banking and asset management have benefited from the use of fair-value accounting. In the case of the former, one noteworthy example is the use of fair values in accounting for acquired goodwill. The elimination of the historic-cost practice of goodwill amortization in favor of a fair-value approach has dampened accountability for overpayment in acquisitions, which in turn has driven up deal volumes and investment-banking fees.⁸² In the case of asset management, the

⁷⁷ See e.g. Power. Another probable factor suggested by an anonymous reviewer is legal changes in 1995 (in the Private Securities Litigation Reform Act) to corporate and auditor liability over certain “forward-looking statements,” which can form the basis for fair-value assumptions.

⁷⁸ Allen & Ramanna.

⁷⁹ Rakesh Khurana, *From Higher Aims to Hired Hands: The Social Transformation of American Business Schools and the Unfulfilled Promise of Management as a Profession* (2007).

⁸⁰ See Power.

⁸¹ See Allen & Ramanna.

⁸² See Ramanna, *Political Standards*.

recognition of fair-value changes in income has accelerated the recognition of unrealized gains as accounting profit, resulting in compensation ahead of delivered performance, a classic moral hazard situation.⁸³

The growth of fair-value accounting represented a shift in the nature of GAAP, away from a contractual or realization view of transactions to a valuation or assumption-driven view. Wanda Wallace, an accounting academic and sometime member of the FASAC through the 1990s, characterized this as shift as a realignment of accounting away from auditing and auditability towards economics and finance.⁸⁴ Indeed, a longtime FASB employee James Leisenring, who has been recognized by colleagues as an enthusiastic supporter of fair-value accounting, noted in an interview in 2011, “I have no opinion on auditing anymore. I’m not qualified to answer auditing questions. I haven’t audited anything in 28 years”.⁸⁵

Fair-value accounting is consistent with the principles of reliability and verifiability to the extent that such current-value estimates are obtained from active, liquid (informationally efficient) markets and are thus objectively auditable. In GAAP, such estimates are now referred to as Level 1 fair values. However, a significant proportion of current-value estimates – for instance, for many derivatives, options, and hedges – are obtained from mathematical models using secondary data or assumptions as inputs. Such estimates are now referred to as Level 2 and Level 3 fair values, respectively. Level 2 and Level 3 do not always appear to meet the criteria of reliability and verifiability, as laid out in CON 2.

The growth of fair-value accounting, from the 1990s through the early mid-2000s, and the subsequent expansion of its scope from Level 1 estimates to Level 2 and 3 estimates likely brought the nature of GAAP in contradiction with the FASB’s own conceptual framework. While that framework was statutorily non-binding, it represented an inconsistency and presented an avenue for criticism of the FASB.⁸⁶ Thus, one hypothesis for the amendments in CON 8 that abandoned reliability and deemphasized verifiability is that these amendments represented an effort by the FASB to update its “constitution” to eventually meet its own evolved practice.

⁸³ See e.g. Mihir Desai, *The Incentive Bubble*, 90 Harv. Bus. Rev. 124, 124–133 (2012); Kothari & Lester.

⁸⁴ Email correspondence, August 2015. See also Power.

⁸⁵ James Stocker, Oral History Project Interview with James Leisenring, Securities and Exchange Commission Historical Society (SECHS) (Apr. 12, 2011), http://www.sechistorical.org/collection/oral-histories/20110412_Leisenring_James_T.pdf (last visited Sept. 2015).

⁸⁶ See e.g. Ross L. Watts, *Conservatism in Accounting Part I: Explanations and Implications*, 17 Acc. Hor. 207, 207–221 (2003).

3.2 Clarifying the Original Intent of the Conceptual Framework

Whereas even some FASB board members have argued that the changes in CON 8 were precipitated by the rise of fair-value accounting, other FASB employees have been quick to refute this explanation. When presented with this hypothesis in an interview, one longtime FASB insider remarked, “I don’t think there’s any doubt that perhaps some people on the outside ... would say that I can’t do fair value because it won’t be reliable... I’m not naïve enough to not believe that a good many people who wanted reliability to mean something different than what CON 2 said weren’t arguing against fair value; they were... A lot of people accused us that you guys just want to make it easier to do fair value.”⁸⁷

As implied in the quote above, to these insiders the changes in CON 8 simply clarified the original intent of CON 2. Indeed, there is some support for this view in the intellectual histories of the conceptual framework in Erb and Pelger and Pelger.⁸⁸ For instance, the latter examines why valuation-usefulness was identified as the sole objective of accounting in the regulatory conceptual frameworks and why stewardship was not included as an additional objective. The paper argues that valuation-usefulness has been long-entrenched in the FASB, particularly amongst some senior staff.

The FASB’s own official explanation for the change in CON 8, as outlined in that publication’s section on “basis for conclusions,” echoes this position. The joint FASB-IASB document argued that “neither [boards’] framework conveyed the meaning of reliability clearly.”⁸⁹ Interestingly, the FASB used the pushback it had received on its suspected misapplications of reliability over the years as a reason for the changes in CON 8, “The comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term *reliability*. Some focused on *verifiability* or *free from material error* to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently think that reliability refers primarily to precision... Because attempts to explain what reliability was intended to mean in this context have proven unsuccessful, the Board sought a different term that would more clearly convey the intended meaning. The term *faithful representation*, the faithful depiction in financial reports of economic phenomena, was the result of that search...”⁹⁰

Halsey Bullen, a longtime member of the senior technical staff at the FASB and sometime project manager of the CON 8 project, noted in an interview, “One of my

⁸⁷ Interview with Subject No. 15, August 2015.

⁸⁸ See generally Erb & Pelger; Pelger.

⁸⁹ FASB, 2010, at 27.

⁹⁰ *Id.*

collateral duties [at the FASB] was responding to inquiries about the conceptual framework... And *the* persistent inquiry that I heard most often, and the difficulty that I encountered most often, from 1983 on was kind of what the board talks about in the basis for conclusions [for CON 8]. People didn't understand the definition of reliability... They tended to equate reliability with verifiability, in other words, 'Is the number auditable?'... They looked at the long phrase 'representational faithfulness' and cruised right by it.⁹¹ But my understanding in talking with the board members who had written and voted in favor of [CON 2] was that they always thought representational faithfulness was the lead quality in the group of qualities referred to as 'reliability'... So this was a lingering concern."⁹²

To Mr. Bullen's point, Robert Sprouse, a board member of the FASB for 12 years from its inception through 1985 and an author of CON 2, was known to be a strong supporter of current values in accounting. Mr. Sprouse held these views even as far back as the 1960s, when such ideas would have been considered "radical." In an obituary of Mr. Sprouse, his successor on the FASB Robert Swieringa noted that he had coauthored in 1962 a document with Maurice Moonitz that argued "for less reliance on the realization concept and for the expanded use of current values."⁹³ Swieringa added, "They advocated the use of current replacement cost for inventories and plant and equipment, the use of discounted present values for receivables and payables to be settled in cash, and the reporting of holding gains or losses from revaluing inventories in income."⁹⁴ Some of these proposals remain controversial to this day, despite the growth of fair values in GAAP.

Robert Sprouse's position on fair values would have likely made it difficult for him to reconcile it intellectually with a notion of reliability that centered on auditability rather than faithful representation. For instance, in many industries, repricing inventory, liabilities, and plant would be a highly subjective exercise that is effectively unverifiable.

3.3 International Convergence Pressures

A third explanation for the removal of reliability in CON 8 derives from the FASB's convergence efforts with the IASB. In 2004, when the project to revise the

⁹¹ The term representational faithfulness is equivalent to the term faithful representation. The former was the FASB's original usage; the latter was adopted partly because it was easier to translate into other languages.

⁹² Interview, August 2015.

⁹³ Swieringa, at 210–211.

⁹⁴ Id.

conceptual framework was first taken on, both boards were eagerly pursuing convergence. And the IASB, with its momentum from European Union adoption of its standards (occurred in 2002 but operational since 2005) and its vast and ambitious standard-setting agenda, was keen to revise its own conceptual framework.⁹⁵ That framework had been inherited from its much lower-profile predecessor, the IASC, and was perceived as a “Reader’s Digest” version of the FASB framework.⁹⁶

One IASB board member from the time noted in an interview, “The timing was good because we [the FASB and IASB] were working on projects together, and it became important that the projects not get impeded by differences in the framework. And also, from the IASB’s point of view, we had been working on some projects where the existing framework was seriously getting in the way of being able to solve important problems. The way that our framework was expressed meant that, in order to reach the conclusions that we thought were the right conclusions on some of the projects, we actually had to be seen to be violating the framework... In particular, in dealing with IAS 37, the provisions on contingencies standard, and when you get to some of the financial instruments stuff, the definitions of assets and liabilities in the framework weren’t really met because of a bunch of probability terms in the definitions and the recognition criteria... So [the framework] was getting in the way, for example, for reaching conclusions on the right accounting for derivatives and guarantees.”⁹⁷

In this context, it is plausible that the FASB conceded to the changes to reliability and verifiability in its conceptual framework as an accommodation to the IASB, in the spirit of achieving broader success by converging U.S. GAAP and IFRS.

4 A History of Conceptual Framework Changes to “Reliability” and “Verifiability”

Table 2 provides a brief timeline of events concerning the conceptual framework changes on reliability and verifiability. Appendix 1 provides brief profiles of some FASB and IASB employees involved in the conceptual framework changes. These listings may help readers navigate the description of events that follows.

⁹⁵ See Camfferman & Zeff, at 359.

⁹⁶ Interview with Subject No. 20, September 2015.

⁹⁷ Interview with Subject No. 19, October 2015.

Table 2: Brief timeline of events concerning the FASB conceptual framework changes on reliability and verifiability.

Date	Event
April 2001	A FASB Special Report says “reliability” is “often misunderstood”
July 2001	FASB staff lead an “educational session” for FASAC members – note shortcomings of reliability in the conceptual framework
August 2001	FASB publishes a paper suggesting changes to the conceptual framework may be necessary because “business and financial activities have changed considerably”
2002–03	FASB and FASAC occasionally discuss issues relating to reliability and fair-value accounting
December 2003	Joint FASB-American Accounting Association conference on reliability; co-sponsored by the Big Four audit firms
April 2004	Joint FASB-IASB meeting – the boards direct their staffs to prepare a plan to revise the conceptual framework
September 2004	FASB receives some pushback from the FASAC on the conceptual framework project – some FASAC members see it as a “Trojan horse” for fair values
October 2004	FASB and IASB formally add the conceptual framework project to their agendas
February 2005	FASB approves the staff plan for the conceptual framework project
February 2005	FASB publishes a document stating that “the Board does not accept the view that reliability should outweigh relevance” on fair-value measurement issues
May 2005	FASB board members vote to replace reliability with “faithful representation” in the conceptual framework
July 2006	FASB issues a Discussion Memorandum outlining the changes relating to reliability and faithful representation
February 2007	FASB hears of comment-letter opposition to the decision on reliability; the board also hears that a minority of constituents support separating “verifiability” from faithful representation
May 2007	FASB board members reaffirm their earlier decision on reliability; they also propose the separation of verifiability from faithful representation and the reclassification of verifiability as an “enhancing” (rather than “necessary”) property of accounting
May 2008	FASB issues an Exposure Draft outlining the changes relating to verifiability
December 2008	FASB hears comment-letter feedback
January 2009	FASB board members reaffirm their earlier decisions on reliability and verifiability
September 2010	The revised conceptual framework is issued

The first public inklings that “reliability” in the conceptual framework could be reassessed came in 2001 with the publication of a report by Wayne Upton, a senior FASB staffer (and later IASB staffer) and key author of CON 7 issued in 2000. The report argued that the term reliability was “often misunderstood.” It added

that the FASB's constituents often took the term reliability to mean "verifiability," and the document reminded readers that the concept also meant representational faithfulness.⁹⁸

Also that year, FASB board member John "Neel" Foster and FASB senior staffer L. Todd Johnson authored a document titled "Why Does the FASB Have a Conceptual Framework?" No reason was given for the issuance of the document, but it did assure readers that "No additional [conceptual framework documents] are currently planned although the Board has proposed a limited amendment to revise the definition of a liability and is exploring the possibility of a broader reconsideration of liabilities and their recognition".⁹⁹ This document did give some warning of upcoming convergence pressures, noting that "the advent of the new IASB may also lead to further development of the framework. As part of its effort to achieve greater convergence of accounting standards internationally, the IASB is considering whether differences in the existing conceptual framework of the IASB and those of national standard setters—such as the FASB—may be impediments to convergence. If so, there may be need to reconsider those frameworks or at least certain aspects of them."¹⁰⁰

As a final indication of things to come, the Foster-Johnson document stated, "the FASB's framework was, for the most part, developed two decades ago. Since then, business and financial activities have changed considerably and have become increasingly complex. As a result, many of the standard-setting issues of today are different and more complex than those that were contemplated when the framework originally was developed. For that reason, some updating of the framework may be both desirable and necessary to enable it to better cope with the issues of today and tomorrow."¹⁰¹

A search of publicly available FASB documents suggests that no further papers on the conceptual framework were released until 2004. But in December of 2003, the FASB in conjunction with the American Accounting Association organized a conference focused on two topics: the reliability of numbers reported in financial statements and notes; and defining the unit of account. The conference was sponsored by the FASB and the Big Four audit firms, and it was attended by board members and senior staff, including two staff directors.¹⁰²

98 Wayne S. Upton, Jr., *Business and Financial Reporting, Challenges from the New Economy*, FASB Special Report 1, 96 (2001).

99 Foster & Johnson, at 1.

100 *Id.*, at 3.

101 *Id.*

102 Report of the Chairman of the FASB to the FASAC, Financial Accounting Standards Board (FASB) (2003), 5.

Professors Laureen Maines and James Wahlen presented a paper at the conference, subsequently published in the journal *Accounting Horizons* under the title, “The Nature of Accounting Information Reliability: Inferences from Archival and Experimental Research.”¹⁰³ The presentation was intended to inform standard setters about the current state of archival and experimental evidence on reliability. One participant at the conference remarked, “The crowd’s reaction illuminated why we needed to discuss reliability and what it means (and does not mean) – there was a lot of disagreement/misunderstanding about what characteristics should comprise reliability. Even Bob Herz, then chair of the FASB, went on a bit of a long rant ... describing reliability – but as I and others pointed out, his comments were actually more about relevance! So even the FASB chair was guilty (in my view at least) of inadvertently commingling relevance into reliability.”¹⁰⁴

Concurrent with the events described above, the FASB was engaging its formal advisory body, the FASAC, on the question of reliability in the conceptual framework. In July of 2001, Todd Johnson had led an “educational session” for FASAC members (who were themselves experts on accounting issues) on the conceptual framework. Mr. Johnson discussed the issue of reliability in the context of what was then a very new and controversial FASB standard – the decision to eliminate goodwill amortization and require fair-value based testing for goodwill impairment. “On the issue of goodwill amortization, the conceptual framework did not provide direct guidance,” he was recorded as saying.¹⁰⁵ “Concepts Statement 2 states that *reliability* is one of the primary characteristics of useful accounting information. Many constituents cited *reliability* as a reason either to support or oppose amortizing goodwill.”

Mr. Johnson stated that some critics of the FASB’s decision had “argued that the *reliability* of financial statements would be undermined if goodwill was not amortized. Others [had] argued that the *reliability* of financial statements would be undermined if goodwill was amortized.” Mr. Johnson explained how the discussion of *reliability* in Concepts Statement 2 provided some help to the Board: “Concepts Statement 2 states that *precision* often is confused with *reliability*... amortizing goodwill over a fixed period, such as 40 years, produces numbers for the income statement and balance sheet that are very *precise*. There is comfort in having such precision in the financial statements, especially if one is expressing an opinion on those statements. However, Concepts Statement 2 also notes that an important

103 See generally Laureen A. Maines & James M. Wahlen, The Nature of Accounting Information Reliability: Inferences from Archival and Experimental Research, 20 Acc. Hor. 399–425 (2006).

104 Email correspondence with Subject No. 27, August 2015.

105 Minutes of Meeting, Financial Accounting Standards Advisory Council (FASAC) (2001), 8–9.

aspect of *reliability* is *representational faithfulness*. If goodwill is not decreasing in value, then amortizing it yields accounting information that is not *representationally faithful* because it depicts goodwill as decreasing when it is not.”¹⁰⁶

In a remarkable foreshadowing of the changes that would eventually be captured in CON 8, Mr. Johnson explained how the board arrived at its final conclusion, “The Board observed that although goodwill amortization produced *precise* numbers, it would not produce *reliable* numbers if those numbers were not *representationally faithful* of the underlying economics.”¹⁰⁷

In a FASAC meeting on December 2, 2002, FASB board member Neel Foster was recorded acknowledging that “the Board could be perceived as being inconsistent in the area [of fair values and reliability]. In some cases the Board simply tells practitioners to do the best they can in arriving at fair value, but in other cases the Board prohibits fair value estimates because it believes those estimates are not sufficiently reliable”.¹⁰⁸ One of Foster’s contemporaries on the board recalled him as being the “most passionate” board member on fair-value accounting during his tenure.¹⁰⁹ Just the previous year, Mr. Foster had coauthored a document with Mr. Johnson suggesting changes to the conceptual framework might be forthcoming.¹¹⁰

In June of 2003, as the FASAC membership was invited to comment on the FASB’s ambitious project to produce a taxonomy of fair-value measurements, the board experienced mixed reactions. The minutes noted, “Several Council members expressed support for the project’s objectives. However, some Council members expressed concerns about more specific issues relating to fair value measurements. Some were concerned that the fair value hierarchy is rigid and would not allow preparers the flexibility needed to make their best estimates. Some noted that there is less precision as one moves down the hierarchy, which brings into question the issue of reliability”.¹¹¹

The FASB polls the FASAC annually for its thoughts on the board’s agenda. FASAC surveys from 2002 to 2003 suggest that reliability was being discussed in the context of fair-value accounting in both years. Then FASB chairman, Robert Herz, noted in 2002, “it also is clear that many constituents (including some users) do not favor moving to a comprehensive fair value approach at this time. In my

¹⁰⁶ Id., at 9.

¹⁰⁷ Id.

¹⁰⁸ Minutes of Meeting, Financial Accounting Standards Advisory Council (FASAC) (2002), 12.

¹⁰⁹ Email correspondence with Subject No. 28, August 2015.

¹¹⁰ See Foster & Johnson.

¹¹¹ Minutes of Meeting, Financial Accounting Standards Advisory Council (FASAC) (2003), 7.

view, in order to move the ball forward, we need to develop a systematic plan to address the relevance and reliability concerns expressed by many.”¹¹² Later, in 2003, he added, “a more principles-based or objectives-oriented approach in these areas would, in my view, imply moving to a full fair value model for financial instruments. While I personally favor such a move, its timing requires that we address and satisfactorily resolve important measurement and display issues and reliability concerns.”¹¹³

Another board member, John Wulff, made the impediments to fair-value accounting presented in CON 2 even more explicit. The record reports him suggesting “an amendment to FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information, to clarify reliability versus relevance trade-off.”¹¹⁴

Even some FASAC members are recorded as weighing in directly. L. Hal Rogero, Jr. of the Institute of Management Accountants suggested, “The move to having more fair value accounting and disclosures is becoming more difficult to deal with. Some fair value amounts are based upon estimates that are so far into the future that reliability is a real issue.”¹¹⁵ John M. Guinan of KPMG commented: “[In] considering fair value measurement requirements, the Board should study and consider to what extent the ... results are objectively verifiable.”¹¹⁶

These discussions came to fore in a March 2004 FASAC meeting where the FASB raised the prospect of formally revisiting the conceptual framework. The FASAC expressed support for the project, although there was some division within the council on how important this issue was: “Some members expressed the view that this is the most important project for the Board to address. Other Council members agreed that the project is important but that [progress on] projects such as revenue recognition ... should not be impeded.”¹¹⁷ One council member recalled that the skepticism to the conceptual framework project on the FASAC was largely among practitioners who viewed the conceptual framework as too theoretical to change anything in practice.¹¹⁸

112 Summary of Responses to the Annual FASAC Survey, Financial Accounting Standards Advisory Council (FASAC) (2002), 32.

113 Summary of Responses to the Annual FASAC Survey, Financial Accounting Standards Advisory Council (FASAC) (2003), 40.

114 FASAC, 2002b, at 38.

115 FASAC, 2003b, at 60.

116 *Id.*, at 79.

117 Minutes of Meeting, Financial Accounting Standards Advisory Council (FASAC) (2004a), 6.

118 Interview with Subject No. 22, August 2015.

On April 22, 2004, the FASB and the IASB held a joint meeting with the objective of moving towards a single conceptual framework. The boards directed their respective staffs to develop a plan to this end.¹¹⁹

At the next FASAC meeting on September 23, 2004, the FASB experienced some skepticism about the scope of the project and its implications for fair-value accounting. This skepticism was perhaps linked to the rather defensive tone struck in a FASB handout to FASAC members before the meeting: “Some FASAC members and other FASB constituents have questioned certain of the trade-offs between relevance and reliability that the Board has made in setting accounting standards. Specifically, they have questioned the appropriateness of the trade-offs that the Board has made in requiring financial statement measures that reflect fair values rather than historical costs. Their underlying presumption seems to be that historical costs, while perhaps not as relevant as fair values, are clearly more reliable. In those instances, they assert that the trade-off between relevance and reliability should favor historical costs rather than fair values.”¹²⁰

The minutes of the September 2004 meeting record the pushback: “Many Council members expressed support for the reconsideration of the conceptual framework. Others expressed concerns that the project may be a Trojan horse toward full fair value accounting. There was concern about the ability to audit fair value measures that must be estimated. Many of the Council members expressed concern about exposure to litigation.”¹²¹ The minutes record FASAC members as suggesting that the FASB “reexamine the idea of conservatism when looking at the criteria for tradeoffs between relevance and reliability.”

FASB board member Edward Trott struck a conciliatory note, stating that “neither this project nor the fair value measurement project is intended to move toward more fair value accounting.”¹²² Todd Johnson was more direct. He stated that “some may have misinterpreted the definition of reliability in Concepts Statement 2.”¹²³

With the September FASAC meeting behind them, the FASB met in October with the IASB and formally voted to add the conceptual framework project to the agenda.¹²⁴ From the beginning though, certain members from both boards

119 Minutes of the Meeting of the IASB and the FASB, Financial Accounting Standards Board (FASB) (2004a), 6.

120 The FASB’s Conceptual Framework: Relevance and Reliability, Financial Accounting Standards Board (FASB) (2004), 1.

121 Minutes of Meeting, Financial Accounting Standards Advisory Council (FASAC) (2004b) 8.

122 *Id.*

123 *Id.*, at 7.

124 Minutes of the Meeting of the IASB and the FASB, Financial Accounting Standards Board (FASB) (2004b).

appeared to have had an endgame in mind. For instance, FASB board member Katherine Schipper warned that the boards “should use discipline to look only at issues that had proved problematical.” Reliability as a qualitative characteristic led directly into recognition and measurement, she noted. FASB chair, Robert Herz agreed, saying that “relevance and reliability and how they related to recognition and measurement was an issue that people were looking for the Boards to address more robustly than they had done in the past.” Ms. Schipper made clear her priorities; she said that she “did not think relevance should be part of this discussion”.¹²⁵

Echoing this sentiment, senior staff member Wayne Upton added that “another thing that was important was to identify the things that would not change. People should not be allowed to think that the Boards might switch to an income statement approach.” IASB board member Jan Engström pushed back, saying that he “did not know that yet.” But IASB board member Mary Barth appeared to agree with Ms. Schipper and Mr. Upton. She said that “if they gave the impression they were starting from scratch, that would raise expectations.” IASB board chair, David Tweedie was more agnostic, saying that “it was a question of when you wanted your fight. If they put out a document saying this, they would get a shoal of letters. People will protest.” He recalled that the IASB had had this experience with other proposals. He cautioned, “People said they had closed their minds, and only wanted to change certain things. This could be perceived as arrogant. They would get a massive distraction up front. It was a hard call.”¹²⁶

At the same meeting, FASB project manager Halsey Bullen proposed that the boards issue a document. “This should say: – why conceptual frameworks are useful tools for setting standards; – why Boards should not have different conceptual frameworks; – why the existing framework needs improvement; – an analysis of the process for improving it.” An observer record of the meeting noted, “The staff thought it was important to try to educate the public and had provided an outline of the structure of a possible paper as an appendix.”¹²⁷ The boards ostensibly agreed. This outline closely resembles the document titled “The Project to Revisit the Conceptual Framework” published in December that year under the authorship of Todd Johnson.¹²⁸ Interestingly, this document is also substantially similar to the handout the FASB staff circulated to the FASAC at the council’s September meeting. It appears that the document had already been prepared when the staff sought the boards’ permission to draft it.

¹²⁵ Conceptual Framework (minutes of the FASB-IASB joint meeting), ISTAR (2004), 4.

¹²⁶ *Id.*, at 8.

¹²⁷ *Id.*, at 7.

¹²⁸ See L. Todd Johnson, *The Project to Revise*.

The FASB met several times in the first months of 2005. By February of 2005, the staff had prepared a plan for the project that the FASB formally approved at its meeting that month. Also at that meeting, board member Katherine Schipper proposed a test for the FASB to determine whether the conceptual framework needed changing: “(a) has something changed since the original framework was developed? and (b) did the original framers err on or omit an issue?”¹²⁹ But the minutes record no further discussion of this proposal, and the test does not appear to have been used in subsequent deliberations on reliability.

A few days after that board meeting, FASB senior staffer Todd Johnson issued another publication on the project, titled “Relevance and Reliability.” As an indication of things to come, the document cautioned, “The Board has required greater use of fair value measurements in financial statements because it perceives that information as more relevant to investors and creditors than historical cost information. Such measures better reflect the present financial state of reporting entities and better facilitate assessing their past performance and future prospects. In that regard, the Board does not accept the view that reliability should outweigh relevance for financial statement measures.”¹³⁰

The next important event in the history of the fall of “reliability” was the FASB board meeting of May 25, 2005. The meeting lasted only 2 h, but here the board formally voted to reverse the then twenty-five-year-old principle that reliability was one of two fundamental qualitative characteristics of accounting. The proposal was formally introduced by FASB program manager Halsey Bullen.¹³¹ Together with IASB staffer Kimberley Crook and FASB staffer Todd Johnson, Mr. Bullen had authored a background paper making the recommendation to replace reliability with representational faithfulness. The background paper noted that the decision had been made in small group meetings with certain FASB board members in November and December of 2004. Somewhat tongue-in-cheek, the paper conceded that a drawback of the change was that “relevance and representational faithfulness” did not have the same alliterative ring as “relevance and reliability.”¹³²

The background paper acknowledged that some board members had been skeptical of the changes, but it did not state whether these were FASB or IASB board members. But, the paper continued, “in the staff’s view, one of the biggest reasons for different (inconsistent?) treatment in applying reliability is that

129 Memorandum: Board Meeting, Financial Accounting Standards Board (FASB) (2005a), 7.

130 L. Todd Johnson, *Relevance and Reliability*, FASB Report (2005), 4.

131 See Memorandum: Board Meeting, Financial Accounting Standards Board (FASB) (2005b).

132 *Conceptual Framework Qualitative Characteristics 1: Relevance and Reliability*, Financial Accounting Standards Board (FASB) (2005), 14.

different Board members mean different things when they say ‘reliability.’ For many, the meaning seems to be verifiability, for some it is precision, for some it may be faithful representation, for a few perhaps all of those plus neutrality. Among constituents, the differences in meaning are if anything much greater.”¹³³

At the board meeting, Mr. Bullen reiterated his message: “many constituents equate reliability primarily with verifiability, not representational faithfulness... those disparities suggest a need to clarify the terminology.” Board members G. Michael Crooch, Leslie Seidman, and Edward Trott expressed support for this position. As did board member Katherine Schipper who nonetheless recognized limits to the solution. The minutes recorded: “Ms. Schipper stated that she supported the staff’s recommendation but that she is concerned that the disagreements over the term *reliability* may be transferred to the new term.” Board chair Robert Herz also verbalized support for Mr. Bullen’s proposal. The minutes do not record board members George Batavick and Donald Young as having made any remarks on the matter.¹³⁴

Former FASB board member James Leisenring was also present at this meeting in his capacity as an IASB board member and as an IASB liaison to the FASB. Mr. Leisenring appeared to leave little doubt that he saw the change as related to the pushback on fair-value accounting, although he appeared to be skeptical that the decision would meet this implicit objective. The minutes note: “Mr. Leisenring stated that he agreed with the staff’s recommendation ... to replace reliability with faithful representation but that he does not believe it will solve the most contentious issue of what is being represented. The issue is that both historical cost and fair value can be faithfully represented, but they are completely different.”¹³⁵

The Bullen-Crook-Johnson background paper also tackled the questions about verifiability, but concluded, at least for now, that verifiability was fundamental to accounting. “The staff also finds itself agreeing with the FASB Concepts Statements and others that the way—the established way, and perhaps the only way—to assure users that they can rely on the information is for it to be verifiable, preferably by direct verification... A purportedly faithful representation that cannot be verified is no more than an assertion.”¹³⁶ Strangely, these strong sentiments did not resurface a few months later when the staff and the boards decided to deemphasize the importance of verifiability in the framework.

While the staff was supportive of verifiability, they had no tolerance for “prudence” or conservatism, which was a key element of the IASB framework and an acceptable convention in CON 2. The language in the background paper was

¹³³ Id., at 13.

¹³⁴ See FASB, 2005b.

¹³⁵ Id., at 7.

¹³⁶ FASB, 2005c, at 9, 14.

especially colorful: “The staff considers the inclusion of neutrality a nonissue. However, differences arise in relating that non-issue, the concept of neutrality, to the accounting traditions of prudence and conservatism. (You might detect some lack of neutrality in the staff’s choice of words in that last sentence, which of course is intended to influence your decision on the next cross-cutting issue in order to achieve a recommended, though not predetermined, result! That heavy-handed humor is actually intended to remind you of the need for and value of neutrality in financial reporting standards.).”¹³⁷

Board members of the FASB at the May 25 meeting appear to have supported the staff positions on verifiability and conservatism without much issue.

In the same month as this important board meeting, the FASB and IASB issued another public document titled, “A New Conceptual Framework Project.” This document listed only Halsey Bullen and Kimberley Crook as coauthors, although the document in places is a verbatim copy of the one issued by Todd Johnson in December of 2004. Also noteworthy is the fact that this document makes no mention of the (proposed) decision to replace reliability with representational faithfulness. Instead, readers are offered a vision of the conceptual framework that trades off relevance with reliability, as in CON 2.¹³⁸

On June 21 of 2005, the FASAC convened again and was briefed of the FASB’s decision to drop reliability from the conceptual framework. A pre-meeting handout suggests the idea originated with the FASB staff: “How can representations be faithful...unless the measures and descriptions are verifiable, and unless the measuring or describing is done in a neutral manner? The staff suggested to the Boards that they cannot be. A purportedly faithful representation that cannot be verified is no more than an assertion. A purportedly faithful representation that is not neutral is a contradiction in terms. In other words, faithful representation requires not only completeness and not subordinating substance to form, but also verifiability and neutrality. For those reasons, the staff recommended replacing *reliability* with *faithful representation*... The Boards agreed with the staff recommendation.”¹³⁹

Mr. Bullen took the lead at the FASAC meeting, explaining the staff recommendations and the boards’ decision. The minutes record no specific opposition to replacing “reliability” among FASAC members. Mr. Bullen also focused on the question of neutrality versus conservatism, ostensibly because the FASB was experiencing some pushback on this question from certain IASB board members.

¹³⁷ Id., at 9.

¹³⁸ See Halsey G. Bullen & Kimberly Crook, A New Conceptual Framework Project, FASB Report (2005).

¹³⁹ Joint Conceptual Framework Project. Financial Accounting Standards Board (FASB) (2005), 9.

Mr. Bullen asked FASAC members for their views on neutrality and conservatism. Here, opinions were more mixed.

Some FASAC members agreed that “excessive conservatism” was not helpful in financial reporting. However, they cautioned that “in practice, problems arise when the accounting is too optimistic and the actual results fall short.” They noted that “The public has an expectation that financial statements will be conservative, particularly after recent corporate scandals and subsequent regulatory actions.” These concerns notwithstanding, the boards eventually purged conservatism from the conceptual framework.¹⁴⁰

The FASB met on numerous occasions over the next several months, but most of these meetings did not focus on “reliability.” Interestingly after the May meeting, the term “reliability” was no longer used in internal documents – the staff and board working with the assumption that the change would eventually be adopted.

Because of disagreements over other parts of the conceptual framework – most notably whether “stewardship” should be retained as an objective for financial reporting as in the IASC framework– it was not until July of 2006 that the FASB officially exposed its decisions on the conceptual framework to constituent feedback.¹⁴¹ This document, a Discussion Memorandum, set a November 3rd deadline for comments from constituents. The boards received 179 comment letters, most opposing the changes to reliability, as noted by the FASB staff summary described below.

On February 28, 2007, about 21 months after the FASB board members officially made their decision on reliability, they heard a staff summary of constituent feedback. Only 50 min were allotted to this part of the meeting despite heavy opposition from constituents. Junior FASB staffer Ann Benson led the discussion on qualitative characteristics. The board heard that “respondents commented most frequently on faithful representation and its components of verifiability, neutrality, and completeness.”¹⁴² Benson reported that “about 80% of respondents commented on faithful representation and its components.” Of these, only “5% of respondents commented favorably on the Boards’ description of faithful representation and its components; 73% commented unfavorably.” Remarkably, the minutes record little reaction from board. Edward Trott is the only board member on record reacting: He expressed “disappointment” on the

140 Minutes of Meeting, Financial Accounting Standards Advisory Council (FASAC) (2005), 9.

141 Camfferman & Zeff, *Aiming for Global*, at 363–365.

142 Memorandum: Board Meeting, Financial Accounting Standards Board (FASB) (2007a), 7.

feedback and suggested that the FASB consider why there is “a misunderstanding ... among constituents.”¹⁴³

In my field interviews with FASB employees from the time period, I probed for more reaction on the negative comment-letter response. In general, the board members were not particularly fazed (for exceptions, see the next section). One FASB board member noted: “You don’t look per se at the number of people [responding]... you tend to look at... what knowledgeable users are saying.”¹⁴⁴ FASB staffer Jeff Johnson explained how the feedback influenced the course of events: “I think we all thought that the comment letters reinforced the going-in opinion that you couldn’t save the word reliability. It meant what it meant to people. It was almost like you were trying to pull a word out of the dictionary and redefine it to mean something that the dictionary didn’t say.”¹⁴⁵

A greater part of the 50 min allotted to discuss constituent opposition at the February 2007 meeting appears to have been spent discussing feedback on the boards’ proposals on deemphasizing “stewardship” in favor of “decision usefulness” as the objective of financial reporting. Earlier, newly seated FASB board member Thomas Linsmeier had expressed concern that the stewardship view would be used to resist the boards’ efforts on fair-value accounting.¹⁴⁶ The FASB staff member handling this part of the meeting, Jeff Johnson, recommended that the boards not hold roundtables at this time to discuss issues related to stewardship. Rather, he suggested “other forms of constituent outreach.”¹⁴⁷

The February meeting also appeared to signal that the “fundamental” status of “verifiability” might be under consideration. The FASB heard that several “respondents suggested that verifiability should not be a component of faithful representation, as something can faithfully represent what it purports to represent without being verifiable.” Such respondents, the board was told, “were concerned that inclusion of verifiability as a component of faithful representation may result in excluding information from financial reporting that is useful and appropriate.”¹⁴⁸ To support their case, the staff had quoted in a meeting handout a comment letter from the International Swaps and Derivatives Association, an industry lobby group: “In our view, the term verifiable would imply that information

¹⁴³ *Id.*, at 8.

¹⁴⁴ Interview with Subject No. 8, August 2015.

¹⁴⁵ Interview, August 2015.

¹⁴⁶ Memorandum: Board Meeting, Financial Accounting Standards Board (FASB) (2006), 5.

¹⁴⁷ FASB, 2007a, at 11.

¹⁴⁸ *Id.*, at 9.

would need to be substantiated or validated for it to faithfully represent the transaction whereas financial statements have historically included estimates where these are considered to be reliable.”¹⁴⁹

FASB staffer Jeff Johnson stated that the staff was “considering whether verifiability should be a separate [qualitative characteristic].”¹⁵⁰

The FASAC was also presented with the summary of constituent feedback on reliability, verifiability, and stewardship during its meeting on March 20, 2007. Unfortunately, no discussion of this feedback is recorded in the meeting minutes.

The next important FASB meeting on the subject was May 2, 2007. As preparation for this meeting, FASB members were presented with a background paper. The staff authors of this paper were Ann Benson, Jeff Johnson, and Li Li Lian, the latter an IASB staffer. Interestingly Halsey Bullen and Kimberley Crook, who had prepared the first background paper for the May 2005 meeting had since moved on, from the FASB and IASB, respectively. Todd Johnson, the senior FASB staffer on the project, was still involved, although he was not listed as an author of the 2007 background paper.

Somewhat ironically, the 2007 background paper used the constituent opposition on the decision to drop “reliability” as a reason to sustain that decision: “The staff thinks that it is clear from the analysis of the comment letters that reliability is not a well-understood term.”¹⁵¹ But the most important proposal in the 2007 paper was that “verifiability” be separated from faithful representation and be included as an “enhancing” characteristic of accounting (together with “understandability” and “comparability”).¹⁵² The paper also made clear that prudence or conservatism was not a qualitative characteristic.¹⁵³

By the authors’ own admission, the ideas in the background paper appear to have been motivated from constituent feedback. But the paper was coy about the source of the feedback, noting, “In cases where the staff quotes a comment letter received, this memo does not identify the respondent and letter number in the text... Respondents are not identified explicitly in the text of this document

149 Objective of Financial Reporting and Qualitative Characteristics—Comment Letter Summary, Financial Accounting Standards Board (FASB) (2007), 21. Note, the letter’s author was not identified in the handout. The quote appears on p. 5 of the original letter. The ISDA, whose members included some of the largest banks, was a longstanding champion of unregulated derivatives markets, a position for which it was shortly to become notorious as the global financial crisis hit.

150 FASB, 2007a, at 9.

151 Conceptual Framework Phase A Redeliberations: Qualitative Characteristics of Decision-Useful Financial Reporting Information, Financial Accounting Standards Board (FASB) (2007), 5.

152 *Id.*, at 6–7, 8–9.

153 *Id.*, at 13–14.

because the staff thinks that comments should be judged on on [sic] the value of the comment without any possible bias that might arise when the source of the comment is known before the comment is read.”¹⁵⁴

To make its case on verifiability, the background paper began by recognizing favorable constituent sentiment: “Some respondents suggested that verifiability should not be a component of faithful representation.”¹⁵⁵ The paper quoted a comment letter by the oil giant Shell: “Financial information is either verifiable or it is not; greater verifiability does not, in our view, equate with greater reliability/faithful representation, nor does it necessarily improve the usefulness of financial information...The emphasis on verifiability will result in future accounting standards that are rules-based rather than principles-based.” Later, the background paper embraced the position of Shell (though not identified by name): “The staff thinks there is some validity to respondent comments that indicated that verifiability should not be a component of faithful representation.”¹⁵⁶

The paper added, “information which perfectly reflects the economic substance of the phenomenon that it purports to represent may not be verifiable, and that fact does not diminish the extent to which it is a faithful representation. Take, for example, a piece of information that is influenced by management’s opinion or management’s intent. While management presumably knows what it thinks or what it intends at a given point in time, verification of that belief by another would not be possible. The fact that the information is unverifiable might render it less useful for decision making in the eyes of financial reporting users, but it does not diminish the extent to which the information is a faithful representation of management’s opinion or intent. Accordingly, while verifiability has an undeniable place in the qualitative characteristics, it does not fit as a component of faithful representation.”¹⁵⁷

The argument concluded, “The staff recommends that verifiability be described as an enhancing qualitative characteristic.” But this conclusion was not unanimous as the document acknowledged, “Some staff members are concerned that identifying verifiability as a qualitative characteristic will over-emphasize the importance of verifiability to decision usefulness. They are concerned that constituents might view the identification of what was formerly a component of a qualitative characteristic as a stand-alone qualitative characteristic elevates its importance for decision usefulness. Other staff members think that identifying verifiability as an enhancing qualitative characteristic, thus

¹⁵⁴ Id., at 1.

¹⁵⁵ Id., at 3–4.

¹⁵⁶ Id., at 6.

¹⁵⁷ Id., at 6–7.

placing it on the same plane as comparability and understandability, actually establishes an appropriate level of importance.”¹⁵⁸

When asked about this disagreement in an interview, a FASB staffer remarked: “To be perfectly honest with you, I’m guessing that memo was written that way to represent the board members’ dissent. We usually take the bullet for that.”¹⁵⁹

The 2007 background paper also acknowledged the constituent support for accounting conservatism: “Many constituents argued that prudence, or conservatism, should be included as a qualitative characteristic or as component of the qualitative characteristic of faithful representation. Some respondents acknowledged that there is a tension between conservatism and neutrality, but argued that similar tensions exist between other characteristics such as relevance and faithful representation. Thus, the fact that a tension exists is not a compelling argument for excluding conservatism. Some respondents argued that it will be difficult to apply the concept of neutrality to determine the appropriate fair value measurement for an asset that does not have a readily determinable fair value. Constituents suggested that it would be appropriate to use the concept of conservatism in such a circumstance, because when there is considerable uncertainty in measurement, the consequences of misstatement in one direction may be more severe than the consequences of a misstatement in the other direction.” But, these arguments notwithstanding, the staff report endorsed the FASB’s previous position on conservatism: “The staff recommends the Boards affirm their decision that conservatism is incompatible with neutrality and therefore is not included in the qualitative characteristics of accounting information.”¹⁶⁰

As might be expected if the background paper did in fact already represent FASB board members’ own positions on the subjects, most proposals from the background paper were accepted at the May 2, 2007 meeting. The meeting minutes note that based on the negative feedback the board received on its proposal to drop reliability, the board had to conclude that the term was not “well-understood.”¹⁶¹ So, the board reasoned, it must be dropped. Board member Thomas Linsmeier, who had replaced Katherine Schipper, had not attended prior meetings. But he is not recorded as raising any questions. This, despite the fact that Mr. Linsmeier had acknowledged the importance of “reliability” in a media interview for CFO magazine shortly before joining the board in 2006.¹⁶²

158 Id., at 8–9.

159 Interview with Subject No. 2, August 2015.

160 FASB, 2007c, at 13–14.

161 Memorandum: Board Meeting, Financial Accounting Standards Board (FASB) (2007b), 4.

162 Ronald Fink & Marie Leone, FASB’s New Seventh Man: A Q&A with new FASB member Thomas Linsmeier, CFO.com (June 23, 2006), <http://ww2.cfo.com/accounting-tax/2006/06/fasbs-new-seventh-man/> (last visited August 2015).

The board members also reversed their previous endorsement of verifiability from 2005 – “A purportedly faithful representation that cannot be verified is no more than an assertion.” The board now agreed with the staff that “faithful representation is attained when the substance of an economic phenomenon is depicted completely and neutrally.”¹⁶³ Perhaps to encourage the FASB board members to accept this about-face, staff member Ann Benson explained that the IASB at its meeting in April of that year had “agreed with the staff recommendation to make verifiability a stand-alone enhancing qualitative characteristic.”¹⁶⁴

The meeting minutes record a single board member, Edward Trott, expressing some concern about the decision on verifiability. “Mr. Trott stated that he believed this was one of the more powerful changes recommended... Mr. Trott stated that he hoped the staff would spend some time with the [Public Companies Accounting Oversight Board], the [U.K. auditing standards authorities], and other international auditing groups because financial reporting and auditing directly intersect on this issue, and there was potential for productive discussions on the link between auditability and verifiability.”¹⁶⁵

Subsequent searches of the FASB archives and interviews with several FASB board members and staffers from the time report no evidence that such a meeting with the PCAOB took place. One FASB employee noted, “I was very disappointed in our relationship with the PCAOB... I had hoped that they would have been a significant inputer [sic] to the FASB... But at that time the PCAOB... was so concerned about confidentiality that we got basically zero input... That always frustrated me.”¹⁶⁶ A former overseer of the accounting profession explained the context, “At that time, I don’t think [the PCAOB’s] role would have been anything other than to look at the work of auditors... The PCAOB was still very much in the startup phase... they were just basically adapting the old standards of the AICPA...”¹⁶⁷

By the end of the FASB board meeting on May 2, 2007, the issues that reliability and verifiability might have posed to fair-value standards had been addressed. FASB staffer Jeff Johnson stated: “faithful representation has replaced reliability

163 FASB, 2007b, at 4.

164 *Id.*, at 6.

165 *Id.*, at 7. The PCAOB was at the time a nascent US regulator, established in the wake of Enron’s failure, to audit the audit firms. In the UK, auditing oversight was at the time the remit of the Financial Reporting Council, as a previous Auditing Practices Board had been disbanded following a government review.

166 Interview with Subject No. 10, August 2015.

167 Interview with Subject No. 24, September 2015.

and since faithful representation does not include verifiability, there is no longer any trade-off between relevance and faithful representation.”¹⁶⁸

The meeting did record some dissent on classifying certain qualitative characteristics as “enhancing” and others as “necessary,” but the minutes (and subsequent interviews with board members) clarify that these dissents had to do with “comparability” not “verifiability.”¹⁶⁹ A few board members would have liked comparability to be considered “necessary.” But in the end, this dissent did not prove a stumbling block for the approval of the proposals in the staff background paper.

There is also no record in the minutes of this eventful meeting of significant board-member discussion on conservatism. The minutes simply note that “the staff does not think that respondents raised any points related to conservatism that were not addressed adequately by the Boards during deliberations.”¹⁷⁰

Following the meeting of May 2007, the question of reliability and verifiability largely appears to have been settled in the minds of the FASB. A meeting on February 20, 2008 included some debate over use of term “accuracy” versus “free from error” as a component of faithful representation. The FASB members decided to use former because latter “could be deemed absolute.”¹⁷¹ However, most board members suggested that they would accept “free from error” to “facilitate the forward progress of the project.”¹⁷² The IASB board members appeared to be in favor of “free from error” somewhat ironically for the same reason as the FASB: “The term accuracy could be interpreted to imply a level of precision that may not be achievable under the conditions of uncertainty that often exist with accounting representations.” The IASB made no secret of the implications of this choice for its agenda on fair-value accounting: “Therefore, some constituents might argue a fair value measurement could not be a faithful representation because of its inherent uncertainty.”¹⁷³

In May of 2008, the FASB and IASB issued a joint Exposure Draft outlining the decisions on the conceptual framework. The comments, which were due by September of that year, were discussed by FASB board members during their meeting on December 10, 2008. The boards received 142 comment letters. The constituent feedback on reliability and verifiability was mixed, but less negative than during the previous exposure in 2006. Yet another FASB staffer, Kristen

168 FASB, 2007b, at 8.

169 *Id.*, at 7–10.

170 *Id.*, at 14.

171 Memorandum: Board Meeting, Financial Accounting Standards Board (FASB) (2008a), 2.

172 *Id.*, at 6.

173 Conceptual Framework Issues Arising During Drafting of Phase A ED and Phase D DP/PV, International Accounting Standards Board (IASB) (2008), 6.

Mathys, had been assigned to the project. Ms. Mathys reported: “the majority of respondents agreed that *faithful representation* is a fundamental qualitative characteristic. Those who disagree do so because, in their view, the Boards have not adequately justified replacing the term *reliability* with the term *faithful representation*... Finally, some respondents think *verifiability* should be a component of faithful representation... Some respondents thought verifiability was not adequately explained in the ED, and they did not understand why verifiability was omitted from faithful representation.”¹⁷⁴

FASB members at the December 2008 meeting briefly discussed the feedback.¹⁷⁵ Board member Leslie Seidman remarked that the board had discussed this criticism before. Board member Thomas Linsmeier expressed “concern that some constituents did not understand why ‘verifiability’ is an enhancing characteristic.” He stated that “the entire system, not just fair value, requires accounting based on some future consideration. The fact that some constituents do not understand this point, and believe that verifiability can be a fundamental characteristic that always exists, shows that there is still some progress to be made in communicating some of the key issues that we are dealing with.” Board member James Leisenring agreed with Mr. Linsmeier and Ms. Seidman but was more skeptical of the opposition: “there is a difference between those constituents who do not understand, and those who simply do not agree.”

The discussion of constituent feedback closed on a positive note as FASB staffer Ronald Bossio offered some good news, pointing out that “certain constituents also expressed appreciation that the ED was more concise than the PV document.”¹⁷⁶

On January 14, 2009, at the height of the global financial crisis, the FASB formally voted to use faithful representation in lieu of reliability in its conceptual framework and to reclassify verifiability as an “enhancing” characteristic of accounting. Strangely, the constituent opposition appears to have been overlooked in the minutes of this meeting as they record “most respondents to the Exposure Draft” as being in agreement with the changes.¹⁷⁷ In April of that year, the board directed its staff to draft the new text of what would become CON 8.

CON 8, which enshrined the changes in the FASB’s conceptual framework, was published September 2010, concurrent with the equivalent IASB updates to its framework.

¹⁷⁴ Memorandum: Board Meeting, Financial Accounting Standards Board (FASB) (2008b), 8–9.

¹⁷⁵ *Id.*, at 9–10.

¹⁷⁶ *Id.*, at 10.

¹⁷⁷ Memorandum: Board Meeting, Financial Accounting Standards Board (FASB) (2009), 5.

5 Evidence from Field Interviews

As the FASB proceeded through its project to revise the conceptual framework, it adopted the narrative that the existing framework (CON 2) did not describe “the meaning of reliability clearly.” Faced with constituent opposition to its decision to replace the term reliability with faithful representation, the FASB argued that the opposition only further reinforced the point that “reliability” was a poorly understood term. These were the primary reasons the board offered in its official “basis for conclusions” for the changes in CON 8.¹⁷⁸

But the changes in CON 8 were not simply semantic. The term reliability was not merely replaced by one still closer to the original meaning. While such a semantic shift was indeed the board’s initial approach in 2005, by the year 2006 it became clear to the board that it would have to make more substantive changes to advance its agenda. (Presciently, board member Katherine Schipper had warned of this in 2005.) So the FASB altered the definition of faithful representation to eliminate “verifiability” as a constituent element. Constituents supportive of fair-value accounting had warned the FASB that “the term verifiable would imply that information would need to be substantiated or validated for it to faithfully represent the transaction.”¹⁷⁹

Perhaps just as significantly, the definition of faithful representation was revised in 2006 and 2007 to eliminate “prudence” or conservatism. While this concept had not been central in CON 2, it had been a primary element of the IASB’s framework. And the FASB and IASB had been alerted to the important contradiction in terms between prudence and fair-value accounting. A comment letter from the boards’ rulemaking equivalent in Switzerland had been very direct: “We think that prudence is a fundamental qualitative characteristic of a conceptual framework; a concept that should be considered when assets and liabilities are to be measured. Fair values are becoming more and more important in future financial reporting especially fair values of level 3 inputs, which means that observable inputs are not available. Those fair values require/allow huge (professional) judgment. This judgement could be abused for aggressive accounting. The concept of prudence/caution as developed in the existing framework could help to prevent some of the misused judgement.”¹⁸⁰

178 FASB, 2010, at 27.

179 Melissa Allen, Melissa Allen to International Accounting Standards Board, Letter of Comment No. 109, No. 1260-001 (2006), 5.

180 Conrad Meyer & Evelyn Teitler, Conrad Meyer and Evelyn Teitler to International Accounting Standards Board, Letter of Comment No. 82, File Reference No. 1260-001 (London: IASB) (2006), 3.

The sequence of events leading up to the changes to “reliability” in CON 8 – particularly the frequent mentions of fair-value accounting in the course of the changes – suggest that the FASB’s official basis for conclusions does not tell the whole story. Given the potential significance of the removal of reliability to the nature of GAAP, I supplement the evidence above with field interviews of key players at the FASB and IASB at the time.

In all, I conducted 27 such interviews. The subjects were chosen for their first-hand knowledge of events leading up to the 2010 revisions to the conceptual framework. Of the subjects, six were FASB board members, seven were IASB board members, four were FASB staffers, three were IASB staffers, and seven were others involved in the process, including advisors and regulators. Beyond these individuals, four further persons contacted effectively declined to be interviewed: one was an IASB board member; one a FASB staffer; the other two regulators.

Each interview lasted about 1 h. Interviewees who requested anonymity on certain subjects have been accorded this courtesy and identified by a unique subject number in the manuscript; in all other cases, interviewees have been identified by name. In cases of extended quotes from interviewees who were granted anonymity, audio recordings of the interviews have been archived.

The primary question posed of all interviewees was what they saw as the main reason or reasons for the changes in CON 8 related to reliability and verifiability.

Responding to this question, senior FASB staffer Todd Johnson noted, “Many of the arguments that were made in board meetings... kept hinging on the question of reliability, and when board members over the years referred to reliability, they were ascribing kind of different meanings to it. Oftentimes they were thinking, well, it’s really vouchability or auditability... That led us to rethink a number of things... [The arguments] tended to be more around fair-value accounting. The argument that had raged on for such a long time was that historical cost may not be terribly relevant but it sure as heck has all kinds of reliability... I think that was one of the aspects... It was happening back in the 90s and even in the 80s... that was the era when inflation was hitting, and there had been talk about constant-dollar accounting and current-value accounting.” On the matter of removing verifiability from the definition of faithful representation, he added, “The motivation for doing some of that was ... we’d gotten to the point of trying to rephrase what some comment letters were saying.”¹⁸¹

Another longtime FASB employee concurred with Mr. Johnson’s view on reliability: “[When] we took on the project of converging the frameworks... we looked at what had been problematic to us in terms of applications of

181 Interview, September 2015.

frameworks... It was clear that the term reliability to many people meant precisely what CON 2 said it did not mean, and that's precision... Many people over the period of time in the late 80 and 90s would say, 'I shouldn't have to recognize this liability, I can't reliably measure it... I won't know whether I'm precisely right.'... The comment letters on so many... projects, particularly as I recall, allowance for doubtful accounts... other post-employment benefits, and certainly, later on, stock options... made obvious, frankly, that reliability was quite dramatically misunderstood."¹⁸²

Halsey Bullen, who had also spent many years at the FASB, largely agreed with the first two perspectives, although the substance of his comments tied more closely with fair-value accounting: "Fair value or not fair value, better called amortized cost, have been themes at the board since it was formed... There's always been, on the board and on the staff, the whole time I was there, and I'm sure it's true today, people who would like to see more use of fair values in financial reporting and people who are concerned that perhaps we should not... In the minds of most of the board members... that's more important than what the concepts said, because that's actually translated into [accounting] numbers... The board almost, almost decided to go to fair-value accounting, I'm told, before I got there in 1980 and 1981... The change that has occurred is that most of the earlier discussions about fair value were about the fair value of property, plant, and equipment... [That was] not necessarily market based... [Then] there was the growth of markets both for financial assets and the other assets... and instead of undiscoverable prices you had partially discoverable prices, and the advocates of fair value said, 'See, now it's easier to do this.'... When I was working on the financial instruments project, we did a whole lot of research where I and [others] would visit banks and say, 'So what are you guys doing?'... We discovered from that, to the surprise of many, they already had the fair value numbers... They were producing what amounted to balance sheets where the bulk of the assets were measured at fair value... I and others spread the news around the board... Did that flow back into the qualitative characteristics [project]? I don't know... But we were thinking more about the advantages and the problems of using more fair values... When we wrote papers, on the staff, and had discussions with the board, we did point to the representational faithfulness [of fair values]... Maybe that elevated that qualitative characteristic a little bit in the minds of board members."¹⁸³

Another FASB employee who spent a very short term at the organization noted: "[Reliability] seemed to have been used as an excuse for not measuring things, not

¹⁸² Interview with Subject No. 15, August 2015.

¹⁸³ Interview, August 2015.

recognizing things... We do a lot of measurement and we do more and more of it. In that timeframe, the fair-value measurement ... standard had just come out. If you simply use the decades-old sense of what reliability meant... there would be many measures you would never ... use; the alternative to not using the measure was to say it was zero or some ridiculously old historical cost..."¹⁸⁴

Jeff Johnson, who served briefly as the FASB staff manager on the conceptual framework project, offered this explanation: "The board had been for a long time... moving toward information that's more useful and maybe less precise than what's historically been in financial statements – there's always a little bit of back and forth about whether, for example, it makes sense to have historical-cost basis or fair-value basis for certain types of information, historical cost being more verifiable... – and so the board was concerned that their hands were being tied by ... the reliability requirements in the framework... One of the objectives of the framework project was to update the framework to... put the qualitative characteristics ... into the proper perspective for the first time so that there wasn't overreliance on historical cost, overreliance on objectivity..."¹⁸⁵

The sentiment that reliability had been misunderstood to mean measurement certainty was shared by two relatively-junior IASB employees interviewed on the subject.¹⁸⁶ A third IASB employee offered a concurring perspective, "Reliability has always been troublesome... Having read God knows how many comment letters... nobody knows what it means... It was misused relative to what we wanted it to mean." The employee added, "We always thought that reliability and faithful representation meant a lot of the same things in the context of the concept statements, and yes, there were a lot of pressures around fair value and estimated fair values in particular. So if you wanted to say, 'This is the best job I can do of estimating fair value,' it would by definition be representationally faithful." On the question of why the IASB took up the project when it did, that employee noted, "There was also a clear perception, among many of us at the IASB..., that the IASB's framework document shared the failings of a lot of the old IASC standards in that it was a Reader's Digest version of the FASB's and that it really needed a thorough relook... We were in a 'let's all shake hands and converge' mood back then, so doing it jointly [with the FASB] made all the sense in the world. From then, it was, 'Where do we start? How about we start from the beginning?' I think there was a perception that 'objectives and

184 Interview with Subject No. 25, September 2015.

185 Interview, August 2015.

186 Interviews with Subject Nos. 5 and 6, August and September 2015.

qualitative characteristics' would be the easiest bits to do. It didn't necessarily turn out that way, but in the spirit of the moment we thought that that would be true."¹⁸⁷

Importantly, none of these IASB employees felt that international convergence pressures drove the FASB's decision-making on the subject. One noted, "I'd be quite surprised if that was ever a reason... To be honest, it was usually the other way around... All this work was being led by FASB staff."¹⁸⁸

Asked about the reasons for the changes in CON 8, a FASB board member reflected, "There were some perceived weaknesses in especially the qualitative characteristics... We figured as long as we have the hood open, so to speak, we might as well try and address those... I remember that the issues of reliability and comparability were among the two more controversial aspects of the existing frameworks... I think the issue was that constituents looked at the word reliability and thought that it meant basically vouchability or verifiability in a very narrow sense... So there was an attempt to try and articulate what we meant [by reliability] in a clearer way."¹⁸⁹

The same board member continued, "Our experience with a number of standards preceding that project included significant concerns about the ability to reliably estimate the amount... I would say AROs [asset retirement obligations] is an example of this... That was a case where people said, 'You're telling us to measure this at fair value! But there's no observable data here. So how can we reliably estimate this?' That's an example of a case where the widespread view was that it was so unreliable that we should change the measurement attribute... As a general matter, any of the standards that had required a fair-value measurement attribute did seem to raise more significant concerns about reliability than other kinds of estimates... You don't really hear people talking about FAS 5 [Accounting for Contingent Liabilities] causing this issue." When probed for other examples where fair-value use raised concerns about reliability, the board member suggested derivatives, over-the-counter type contracts, and principal-to-principal transactions, noting, "There were concerns about Day 1 gain recognition when a dealer enters into [such] contracts."¹⁹⁰

Asked specifically about how the changes in CON 8 related to the FASB's standard on fair-value measurements (SFAS 157), this board member noted, "Both of them reflect a change in views about how you reflect reliability in accounting...

187 Interview with Subject No. 20, September 2015.

188 Interview with Subject No. 5, August 2015.

189 Interview with Subject No. 9, September 2015.

190 Id.

The changes in CON 8 are consistent with SFAS 157... I think the concept statement and [SFAS] 157 are quite compatible.”¹⁹¹

The same board member also reflected on the considerable comment-letter opposition the FASB faced over its decision on reliability: “The reason that constituents wanted to retain reliability was that they were still perceiving it as some kind of precision associated with the estimates... I think there was a bit of a concern that if there was no ‘threshold’ for reliability, coupled with a fair-value measurement, then there would never be an argument for not recognizing something... I think people had perceived the existing conceptual framework to say... there’s gotta be some level of reliability before we’re comfortable recognizing things in the financial statements. I think the combination of these changes led people to believe that it was potentially going to take off the table that reliability would ever be a legitimate reason not to recognize something... You could see how the trend in [our] decisions could be of concern to stakeholders...”¹⁹²

Four other FASB board members who were interviewed offered largely similar perspectives on the CON 8 decisions – that the FASB had a long experience with certain constituents interpreting reliability to mean auditability or verifiability, that this was never the intent, and that the FASB took this opportunity to clarify the conceptual framework.¹⁹³ Two agreed that fair values played some role in the decision to revise the framework, particularly Level 3 fair values that had been criticized as difficult to audit;¹⁹⁴ two denied any connection between fair values and the conceptual framework changes.¹⁹⁵

On the subject of separating verifiability from faithful representation and classifying it as “enhancing” rather than “necessary,” one FASB board member opined: “One of the real benefits [of CON 8] was the idea of having the two tiers of qualitative characteristics... The way it was done was to give flexibility to the Board in ... the weighting of verifiability [when setting new standards]... This decision had implications for any decision... on measurement.”¹⁹⁶

Another FASB board member went further on this subject, even suggesting that CON 2 had erred, “Anything can be very, very relevant and very, very representationally faithful and not very verifiable.” He said that CON 2 got this idea wrong, but “not seriously wrong... They were the originators... you’ve got to

¹⁹¹ Id.

¹⁹² Id.

¹⁹³ Interviews with Subject Nos. 8, 10, 12, and 13, August 2015.

¹⁹⁴ Interviews with Subject Nos. 8 and 10, August 2015.

¹⁹⁵ Interviews with Subject Nos. 12 and 13, August 2015.

¹⁹⁶ Interview with Subject No. 10, August 2015.

give the first inventor a little credit for being that and not necessarily have the experience. We learned over the years from reading the comment letters. The framework only gets tested by [reading] people's explanations of their views on standards-level issues... With hindsight, it wasn't optimal, it was sub-optimal, the way it was placed."¹⁹⁷ This sentiment was perhaps the clearest indication of the conceptual framework as an evolving document, informed by constituent feedback and the FASB's own experiences.

I also interviewed several FASB constituents, including one official who served as a direct overseer of the FASB at the time. He/she explained the changes to reliability in CON 8 as follows: "As you move further down the line, away from historical cost, into use of modeling and predictive analysis and trying to make more estimates and more judgments ... I think what they tried to do is simply respond to that evolution in financial reporting. ... What you look at in a set of financial statements is not the stewardship model [anymore]... it's far more complex today... I would look at it as a natural evolutionary step in their process."¹⁹⁸

In the historical sequence of events presented in Section 4, the staff appears to have played an important role – authoring the two key memoranda that, respectively, eliminated reliability and deemphasized verifiability in the conceptual framework. Accordingly, I probed the staff on their role. Longtime FASB staffer Halsey Bullen demurred when asked whether the idea to replace reliability with faithful representation originated with him: "Who came up with it? It's very difficult to tell... The fact that you were first to articulate something that was on the back of other people's minds means [little]... As staff, we do focus more completely on the issue that we're in charge of, whereas the board members have other guys bringing stuff to them on different matters."¹⁹⁹

Another FASB staffer who was involved with the memorandum suggesting verifiability be reclassified as "enhancing" partially agreed with Mr. Bullen's perspective: "A lot of stuff happens behind the scenes. Usually the public board meetings and the minutes that describe them are – I don't want to say – scripted; but you don't ask questions that you don't already know the answers to. So I wouldn't have gone to the board if I didn't know that I had [their support]."²⁰⁰

¹⁹⁷ Interview with Subject No. 15, August 2015.

¹⁹⁸ Interview with Subject No. 24, September 2015.

¹⁹⁹ Interview, August 2015.

²⁰⁰ Interview with Subject No. 2, August 2015. The instrumental role of the staff in FASB decision-making raises the question of whether the staff are adequately qualified to hold such responsibility. The process for selecting FASB staff, even senior staff, is poorly understood publicly and is not subject to the same external scrutiny, however cursory, as for selecting board members.

Because I had the opportunity to interview several participants, I also asked all interviewees to identify FASB and IASB board members and staffers who in their view were thought leaders of the conceptual framework project around reliability. Several names were raised consistently across the interviews. On the FASB side, senior staffer Todd Johnson and board member Katherine Schipper were mentioned most often. On the IASB side, four board members were most commonly cited, often as a group: Mary Barth, James Leisenring, Warren McGregor, and Patricia O'Malley. In fact, one IASB employee even referred to this group as the IASB's "Big Four."²⁰¹ FASB chair Robert Herz was mentioned as an effective manager, although few identified him as being particularly passionate about the subject. IASB chair David Tweedie was not identified as having strong views on the question of reliability, but he was cited for his vigorous dissent of the boards' decision to deemphasize "stewardship" from its discussion on the objectives of financial reporting.

Warren McGregor, one of the IASB board members identified by peers as an intellectual leader of the project, offered this perspective on CON 8: "The main reason why the conceptual framework came about... was that there just happened to be a collection of like-minded people on the International Accounting Standards Board at that time... a collection of like-minded people who saw an opportunity to make some changes to the conceptual framework ... the frameworks had been in place for quite a number of years and it seemed timely, given the collection of individuals, to update it, upgrade it, and try and improve it in some areas where we, through our own experiences, had felt that there was a need for improvement. We identified reliability as one of those areas where there were strongly held views."²⁰²

On the demand for the changes within the FASB, Mr. McGregor continued: "I think the FASB had a particular problem because of the use of 'probable' in the definition of reliability... and the notion of 'reliability' coming together in the U.S. context to produce a very high recognition threshold that I don't believe was the intent of the drafters to the FASB framework... The FASB said 'we need really to make that clear because it flies in the face of the notion of neutrality.'"²⁰³

Then, he added: "The other contextual setting that was very relevant as well was that there had been a lot of work done on measurement at the standards level, in particular through the development of the fair-value notion... You had the standard setters who were trying to improve financial reporting ... were seeing that fair value was a very robust and powerful mechanism for achieving

201 Interview with Subject No. 20, September 2015.

202 Interview, October 2015.

203 Id.

some fairly significant improvements in financial reporting... We had a concern that some were using [reliability] for failing to recognize assets and liabilities when they should be recognized... Practitioners were using that recognition criterion as a blocker... The advent of fair value enabled [our] concerns to be leapfrogged in a way... We can estimate fair values; you don't need to look to a market... The movement towards the greater use of fair value... sort of led to the push by us into some rethinking about how we should express the framework... We felt that you still have to keep a notion of 'reliability,' as we as standard setters originally intended for it to be used, but sort of peel it back and focus on what we saw as the essential elements of that, which then could work alongside 'relevance.'"²⁰⁴

On the substantial comment-letter opposition that the boards experienced over their decision on reliability, Mr. McGregor added: "I think we were probably surprised at the numbers [of opponents]. We didn't anticipate such a widespread view that the changes shouldn't be supported. I think we probably interpreted that ... as being a function of two things: We knew that there'd be some who would have seen this as the thin edge of the wedge, the greater use of current values; And some that really don't believe in neutral measures – they believe that certain elements should be treated differently than other elements, that certain circumstances should be treated differently than other circumstances." He also reflected on the implicit support from the financial-services sector: "Financial analysts... were influential in their own way... There were [also] investment banks who were very keen on the use of fair value, so that was tied up with this whole development. But I don't recall any of those being particularly bullish about conceptual framework developments."²⁰⁵

IASB board member Patricia O'Malley, also identified by peers as a thought leader in the conceptual framework project on reliability, offered this assessment of the changes: "The timing was good because we [the FASB and IASB] were working on projects together, and it became important that the projects not get impeded by differences in the framework. And also, from the IASB's point of view, we had been working on some projects where the existing framework was seriously getting in the way of being able to solve important problems. The way that our framework was expressed meant that in order to reach the conclusions that we thought were the right conclusions on some of the projects we actually had to be seen to be violating the framework... In particular, in dealing with IAS 37, the provisions on contingencies standard, and when you get to some of the financial instruments stuff, the definitions of assets and liabilities in the framework weren't

204 Id.

205 Id.

really met because of a bunch of probability terms in the definitions and the recognition criteria... So [the framework] was getting in the way.”²⁰⁶

Asked to explain why the term reliability had to be removed, Ms. O’Malley explained: “All we were trying to do is actually use the words that the boards used in the first place and that had got completely misused in practice... People had been using the term for years to somehow be a substitute for measurement precision. And it basically had nothing to do with that... We came to the conclusion that the only thing we could possibly do is change the word... Every time we wanted to do something that required more advanced estimation techniques, or we wanted to move a measurement basis from some kind of allocated historical cost to a more current measure, people would always say we can’t do that because it’s not reliable... It’s absolutely true that people had misunderstood [reliability] for years. And to the extent that that misunderstanding was there, then any attempt to try to update the measurement technology could be seen to be moving to something that wasn’t in accordance with the framework.”²⁰⁷

6 Interpretations and Implications

Four themes in particular emerge from the evidence summarized in the two previous sections. First, there is indeed support for the FASB’s official claim that the changes to reliability in CON 8 were motivated by clarifying the original intent of CON 2. Particularly among a small group of longtime FASB employees, some of whom had been involved in the decisions around CON 2, the view in practice that equated reliability with verifiability was anathema.

Second, there is also support for the hypothesis that the removal of reliability from the conceptual framework was motivated by a desire to legitimize and further propagate fair values in accounting. In fact, even for some of those who argued that the original intent of CON 2 had been misunderstood, the objective had always been more current-value estimates in accounting. It appears that there were two sets of employees at the FASB and IASB at the time. The first group, mostly those from a practitioner background, saw the change as relatively innocuous given the poor historical record of the conceptual framework in influencing actual GAAP developments. The second group, chiefly academics and longtime standard setters, saw the change as potentially profound – with the ability to lock into GAAP the shift towards more fair-value accounting.

²⁰⁶ Interview, October 2015.

²⁰⁷ Id.

Third, there is almost no support for the hypothesis that pressures to converge U.S. GAAP with IFRS drove the FASB to accept the changes to the conceptual framework. If anything, a number of interviewees noted the important role of Americans both at the FASB and IASB in this project.

Fourth, the decision to remove verifiability from the definition of faithful representation appears to have been an afterthought, motivated by constituent feedback. While those with an agenda on fair-value accounting had identified reliability as a key impediment, it was not until the standard setters were well into the process that they realized verifiability had to be addressed as well. Given their objectives in replacing reliability, the decision on verifiability was relatively straightforward.

The notion that the conceptual framework was revised at least in part to accommodate past and future standards on fair-value accounting is significant as a matter of record. It suggests that the official explanation for the changes was at best incomplete. The “basis for conclusions” is part of the historical record that the FASB reports to justify changes in GAAP. Academics, practitioners, students, and even standard setters often refer to the basis for conclusions as an authoritative source of the intellectual history of GAAP developments. If this record is abbreviated to reflect only certain points of view, it risks eroding the public’s trust in the FASB’s internal practices and procedures.

Reflecting on the basis for conclusions on CON 8, a senior FASB staffer lamented: “The explanations for the changes that were made from CON 2 appears to have been abbreviated considerably from the earlier drafts that I was involved with, particularly the reasons for adopting representational faithfulness as a replacement for reliability. Indeed, that particular discussion in CON 8 can only be described as quite terse. Earlier drafts were more robust.”²⁰⁸

Perhaps most significantly, the evidence linking fair-value accounting to the changes in CON 8 underscores the role of conceptual narratives in regulation. The changes to the conceptual framework were initialized over 10 years after – and finalized nearly 20 years after – the substantial reemergence of fair values in accounting in the early 1990s. Moreover, the FASB’s conceptual framework has no official basis in the hierarchy of U.S. GAAP: Although it has the look and feel of a “constitution” for GAAP, the conceptual framework is an advisory document, intended primarily to inform the FASB in its own rulemaking activities, to keep GAAP consistent and within some broad principles.²⁰⁹ These observations raise the question: Why bother? After all, had not the fair-value train already left the station?

208 Email correspondence with Subject No. 1, August 2015.

209 See e.g. Foster & Johnson.

Here, I argue that the history and political economy of fair-value accounting is germane – because it generates criticism of the FASB and the appearance of capture. These, in turn, motivate regulators to manufacture a conceptual narrative that can refute critics, particularly, on the claim of capture.

Starting in the early 1990s, the FASB more consistently pursued the use of fair values in accounting. The initial impetus for fair values in that period was likely the need to mark down to market insolvent long-term financial assets at certain savings-and-loans institutions. Perhaps somewhat naïvely, historic-cost accounting had been blamed for such non-impairment. Downward valuation of assets, even illiquid and hard-to-value assets, is prudent financial-reporting practice, consistent with historic-cost accounting. But the FASB had at best an ambivalent relationship with prudence (as an accounting concept), and the use of mathematical modeling for downward valuations of certain financial assets became more common over time for upward valuations as well, in line with financial industry practice.

At least part of the FASB's drive towards fair values through the 1990s and 2000s can be attributed to the growing financialization of the U.S. economy and to the incentives of players in financial-services industries such as investment banking and asset management.²¹⁰ Fair values, in certain cases, accelerated the recognition of unrealized gains in reported income, which in turn drove compensation. In other cases, fair values mitigated accountability for expenditure and loss recognition, again boosting profits and potentially compensation.

The FASB experienced pushback from certain constituents, notably smaller firms, some non-financial firms, and some commercial banks, on its use of current values in accounting.²¹¹ As the FASB's own documents indicate, these constituents had noted that valuation quotes not drawn from liquid markets failed to meet the standards of reliability set out in CON 2. Such valuation estimates were unverifiable. But the pursuit of fair values continued in the face of this conceptual opposition.

Eventually, it appears, by the early 2000s the conceptual dissonance between the rise of fair-value accounting and the centrality of reliability and verifiability in CON 2 became significant enough to address directly. Aided by a young and vigorous IASB, some of whose members (including its chair) were deeply

210 See e.g. Yuri Biondi, *Empowering Market-Based Finance: A Note on Bank Bailouts in the Aftermath of the North Atlantic Financial Crisis of 2007*, 6 *Acc., Econ. & Law* 1, 79–84 (2016).

211 For a perspective from Japan, see the commentary by Yoshitaka Fukui and Shizuki Saito in this volume.

committed to fair-value accounting, the FASB embarked on an ambitious project to revise its conceptual framework. The changes to the framework's list of accounting's "fundamental qualitative characteristics" mitigated the scope for intellectual resistance to fair-value accounting on the FASB's own grounds. Now, any opposition to fair values on the basis of reliability, verifiability, or prudence can be summarily dismissed as outside the scope of the FASB's terms of reasoning.

These changes in CON 8 exemplify a phenomenon I describe as conceptual veiling.

Conceptual veiling occurs when regulators provide a conceptual narrative to cover for actions that may generate criticism. A conceptual narrative is a system of axioms intended to explain some real-world phenomenon. Put differently, it is an ideology for how (some aspect of) the world works. In this sense, conceptual veiling is a tactic that involves regulators embracing a peculiar ideology designed to deflect criticism.

The nature and intensity of engaging in conceptual veiling suggests that it is a substantive activity, and the criticism that is intended to be forestalled through the veiling is thus also substantive. An example of such criticism, as it applies in the case studied here, is the suspicion of capture.

More formally, from the perspective of the regulator, there are both costs and benefits to conceptual veiling, which can explain its equilibrium supply.

On the costs side, it is time consuming for regulators to engage in conceptual veiling, because it distracts their attention from other activities, be they activities that favor special interests or the general interest more broadly. For instance, this study documents the substantial commitment in time by board members and senior staffers at the FASB and IASB to the revisions in the conceptual framework that eliminated reliability. This aspect alone of the conceptual-framework revisions spanned over five years from start to finish.

Also adding to the costs of conceptual veiling is the observation that embracing a given conceptual justification usually involves taking sides in an ideological debate, thereby relinquishing competing ideologies. This has the associated effect of lowering public perception of regulatory neutrality and narrowing the regulators' appeal.²¹² In the case of CON 8, the changes to the conceptual framework have placed the valuation or decision-usefulness view of accounting at the intellectual center of the FASB, to the exclusion of the contractual or stewardship view. In this sense, conceptual veiling has closed off certain options for the accounting regulators, options that can be useful

²¹² See e.g. Kwak.

mechanisms to evoke trust with the general interest or its agents after the next financial crisis, if there is indeed then a renewed focus on corporate stewardship.

More cynically, conceptual veiling, by closing-off competing conceptual options, also forgoes vehicles for regulators to attract the attention of a wider spectrum of special interests. For instance, while certain financial-market intermediaries supported the elimination of reliability from CON 8, several players from amongst commercial banking, non-listed companies, and national accounting authorities were opposed to this change. The FASB's actions could thus have hobbled its appeal amongst this latter group of special interests. The emergence of the Private Company Council, as a would-be competitor to the FASB on private-company accounting rulemaking, can be understood as a political response by "losing" special interests on the fair-value accounting issue.²¹³ The Private Company Council could eventually rival the FASB as a supplier in the special-interest market for accounting rules.

Notwithstanding these costs, conceptual veiling can be net beneficial to regulators. The key value to regulators from veiling is deflecting criticism – notably, suspicions of capture – thereby sustaining and advancing their own credibility, particularly in times of enhanced public scrutiny. As noted in Section 2, the predecessor body to the FASB – the APB – was eliminated under clouds that it had become too close to certain special interests. So, there is precedent for the FASB to worry about its own survival. Conceptual veiling provides intellectual cover and legitimizes positions that could otherwise be attributed to capture. As Kwak notes, criticisms of regulatory outcomes obtained under a conceptual framework can always be attributed to "the ongoing contest between rival ideological systems," so "it will be impossible to prove" that capture "is the determining factor behind regulatory outcomes."²¹⁴

Note that it is not necessary for the regulator to be actually captured; just the perception of capture is sufficient. Moreover, it is possible that capture is not of the "hard" form, as it usually envisioned – that is, involving a quid pro quo arrangement between regulators and special interests.²¹⁵ Rather, capture can be "softer" – a "cultural capture" that emerges from a set of "shared understandings" (e.g., between FASB members and investment bankers) about how the (accounting) world ought to look.²¹⁶

²¹³ See e.g. Ramanna, Political Standards.

²¹⁴ Kwak, at 79.

²¹⁵ See e.g. Stigler.

²¹⁶ See Kwak.

For readers skeptical that revising an abstract conceptual framework actually matters to the FASB's long-term existence, Young provides a convincing counter argument.²¹⁷ She describes how significant conceptual rhetoric is to the FASB's own construction of its legitimacy. Moreover, this construction feeds into perceptions of the FASB's legitimacy by its immediate overseer, the SEC, and eventually by Congress and the courts. Young suggests that wider perception of its goodness is important to the FASB for instrumental reasons: "FASB members and staff are continuously engaged in efforts to persuade individuals located outside this entity that its work is valuable, appropriate, useful, and correct."²¹⁸

Beyond the benefits to regulators from conceptual veiling, the special interests engaged in capturing regulators, to the extent such capture is real rather than merely suspected, can also demand or encourage its veiling. Such veiling mitigates the likelihood of the capture being (i) discovered (which, in turn, can impose reputational costs on perpetrating special interests) and (ii) reversed through the political process.

In these circumstances, the general interest, which is often left to bear the costs of regulatory capture, is unlikely to resist its veiling because the general interest is, after all, the target of this obfuscation. Certainly, competing special interests to those perpetrating the capture and some agents for the general interest might well be aware of conceptual veiling, but, as evidenced by their inability to prevent capture, their capacity to thwart such veiling is likely limited.

Conceptual veiling can be related to, but, even if so, is distinct from, the notion of cultural capture, which postulates that a "regulated industry can shape policy outcomes through influences other than material incentives and rational debate."²¹⁹ Whereas conceptual veiling describes regulatory responses to the appearance (and potential allegations) of capture, cultural capture describes a mechanism for special-interest capture. In this sense, cultural capture can precipitate conceptual veiling.

In the case of the changes to the conceptual framework described herein, those who championed the valuation view at FASB meetings and workshops may well be "culturally captured" – unwitting participants in the process that eventuated in conceptual veiling. The result can be a system where special interests and regulators seeking to advance more fair values in GAAP and to shield themselves from the public costs of fair-value accounting are now better off.

²¹⁷ Young, *Constructing, Persuading and Silencing*.

²¹⁸ *Id.*, at 622.

²¹⁹ Kwak, at 78. The notion of cultural capture shares some similarities with Antonio Gramsci's notion of cultural hegemony, although cultural capture is less sweeping, more precise, and less conspiratorial. Cultural capture is also a manifestation of Hegel's "civil society."

Conceptual veiling is related to the phenomenon of regulator covering-up (labelled CYA or “cover your a***”), which, while, widely acknowledged by journalists covering regulatory behavior, has not been developed, to my knowledge, as an idea in the academic literature on regulation.²²⁰

Regulator CYA is described as a cultural tendency amongst bureaucrats to diffuse criticism and deflect accountability. It is suspected to originate from the asymmetric loss function most bureaucrats experience, which is that they are often blamed for failures but rarely credited with successes. This loss function breeds risk aversion, which leads to regulator CYA.

William Safire describes the methods of regulator CYA as follows: “A bureaucrat adept at CYA (a) likes to employ passive constructions (see ‘Mistakes were made’), (b) follows up a meeting or phone call with a self-serving memcon – ‘memorandum of conversation,’ (c) routes memos to and through as many other bureaucrats as possible, thereby spreading the risk of future criticism, and (d) ‘papers the file’ with memoranda sometimes supporting and sometimes contradicting his or her position.”²²¹

Conceptual veiling is similar to regulator CYA in that both involve manufacturing cover against criticism. But whereas regulator CYA is attributed to regulator risk-aversion, conceptual veiling is associated with a regulator seeking protection against scrutiny of risky regulation. I postulate conceptual veiling in situations where regulators are liable to being second-guessed, perhaps because of suspicions of capture.

In the extreme case, the conceptual veiling over fair-value accounting, if true, can also precipitate a “political bubble.”²²² This is defined as “a set of policy biases that foster and amplify the market behaviors that generate financial crises... Rather than tilting against risky behavior, the political bubble aids, abets, and amplifies it.”²²³ In the global financial crisis of 2008, fair-value accounting played a catalytic if not central role. And fair-value accounting has been implicated in other crises in the past – e.g., the fall of Enron. If the continued progression towards more unverifiable estimates in accounting is unchecked by other governance mechanisms in the economy, we may be faced with another costly crisis involving

220 See e.g. William Safire, *On Language; Glossary of a Scandal*, The New York Times Magazine, Aug. 1987.

221 William Safire, *Safire's Political Dictionary* (2008).

222 Nolan McCarty, Keith T. Poole & Howard Rosenthal, *Political Bubbles: Financial Crises and the Failure of American Democracy* (2013).

223 *Id.*, at 14.

fair-value accounting.²²⁴ And the role of CON 8 in enabling the “political bubble” at the center such a crisis would be difficult to ignore.

Conceptual veiling may well be seen in contexts beyond accounting regulation, as diverse as food labelling. For instance, some scholars of the political economy of genetically modified (GM) foods have noted that food regulators sometimes dismiss GM opposition as being elitist and anti-poverty.²²⁵ By framing GM foods as imperative to solving global hunger, food regulators can on conceptual grounds dismiss opposition to their (unlabeled) proliferation and associated concerns that the regulators themselves are too close to the agribusinesses behind GM foods.

Closer to the context of accounting regulation, conceptual veiling can help us understand why regulatory forbearance is a persistent theme in bank supervision, despite public concerns about the sometimes-cozy relationship between bankers and their regulators. Here, regulators have embraced elegant theories about what causes banking crises, in particular, framing such crises as being due to temporary market illiquidity rather than poor decision-making and bad credit extended by the banks.²²⁶

With this framing, regulators are able to construct creative vehicles for insolvent banks to continue under effective public subsidy. To illustrate, in crafting standards that evaluate and monitor the financial stability of banks, regulators have controversially included “deferred tax assets” as an element of prime-quality bank capital. Deferred tax assets reflect, in part, the implied benefit a hitherto loss-making corporation would receive from carrying forward those losses to offset taxes incurred on future profits. Implicit in treating deferred tax assets as prime-quality capital is the assumption that loss-making banks will survive and eventually turn a profit – an assumption supported largely by the logical circularity that regulatory forbearance for loss-making banks will continue.

7 Conclusion

Starting in the 1990s, the proportion of fair-value based standards in U.S. GAAP increased considerably. This increase coincided with the increased financialization of the U.S. economy. Financial-services industries such as investment banking

²²⁴ See e.g. Yuri Biondi & Pierpaolo Giannoccolo, *Share Price Formation, Market Exuberance and Financial Stability Under Alternative Accounting Regimes*, 10 *J. Econ. Interaction & Coordination*, 333, 333–362 (2015).

²²⁵ See e.g. Reece Walters, *Crime, Bio-Agriculture and the Exploitation of Hunger*, 46 *The British Journal of Criminology* 26, 26–45 (2006).

²²⁶ See e.g. Admati & Hellwig.

and asset management use fair values on a regular basis, and, moreover, executives from both these industries have incentives to see their increased use in GAAP.

As the FASB expanded the use of fair values, it faced criticism from some constituents that such standards were inconsistent with longstanding accounting principles of reliability and verifiability, which were enshrined in the FASB's own conceptual framework. Nevertheless, the growth of fair values continued.

In the early 2000s, the FASB initiated a convergence program with the newly formed IASB. This convergence program included an effort to harmonize the conceptual framework of both boards. As the two boards began to revisit their frameworks, they proposed in 2006 to replace the term reliability with faithful representation. The FASB argued that the term reliability had been misunderstood in practice and that its original intent was for reliability to mean something closer to faithful representation.

These changes notwithstanding, the FASB continued to define verifiability as part of faithful representation, arguing that a “purportedly faithful representation that cannot be verified is no more than an assertion.” But by 2008, the FASB had reversed course here as well – removing the notion of verifiability from the definition of faithful representation and classifying the former as an “enhancing” rather than a “necessary” or “fundamental” property of accounting. Again, the FASB maintained that these changes were consistent with its original intent. In 2010, the changes to the conceptual framework described above were formalized for both US GAAP and IFRS.

Drawing on primary archival resources and field interviews, I find evidence suggesting that the changes to the conceptual framework can be understood as the FASB attempting to legitimize its program on fair-value accounting.

I argue that the evidence is consistent with the proposition of conceptual veiling in accounting rulemaking. The changes to the conceptual framework have provided conceptual cover to regulators and special interests advancing a fair-value agenda; it has deflected the appearance of capture over fair-value accounting. This conclusion is especially troublesome given the role of fair-value accounting in prior accounting scandals such as Enron and financial crises such as those of 1929 and 2008.

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Appendix 1: Brief Profiles of Some FASB and IASB Employees Involved in the Conceptual Framework Changes on Reliability and Verifiability

Mary E. Barth, Board member, IASB, 2001–09; Academic advisor, IASB, 2009–11; Professor of accounting at Stanford prior to, during, and after her IASB appointments.

George J. Batavick, Board member, FASB, 2003–08; Comptroller at Texaco prior to his FASB appointment.

Ann Benson, Staff member, FASB, 2006–07; Graduate student at University of Notre Dame prior to her FASB appointment; Manager at KPMG after her FASB appointment.

Halsey G. Bullen, Staff member, FASB, 1983–2006; Studied under Robert Sprouse at Stanford; Worked at Haskins & Sells (now Deloitte) prior to his FASB appointment; Retired from the FASB.

G. Michael Crooch, Board member, FASB, 2000–08; Partner at Arthur Andersen prior to his FASB appointment.

Kimberley Crook, Staff member, IASB, 2001–05; Staff member at the New Zealand Institute of Chartered Accountants after her IASB appointment, then partner at Ernst & Young.

John M. “Neel” Foster, Board member, FASB 1993–2003; Vice president and treasurer at Compaq prior to his FASB appointment; Independent consultant and member of the boards of AIG and PJM Interconnection after his FASB appointment.

Robert H. Herz, Board member, IASB 2001–2002; Board member and chair, FASB, 2002–10; Partner at PricewaterhouseCoopers prior to his FASB and IASB appointments.

Jeff Johnson, Staff member, FASB, 2002–08; Worked at PricewaterhouseCoopers prior to his FASB appointment; Worked at General Electric after his FASB appointment.

L. Todd Johnson, Staff member, FASB, 1979–1982, 1990–2009; Professor of accounting at Rice prior to his first FASB appointment; Professor of accounting at University of Houston prior to his second FASB appointment; Retired from the FASB.

James J. Leisenring, Board member, FASB, 1987–2000; Board member, IASB 2001–2010; Staff member, FASB, since 2010; Chairman of the AICPA Auditing Standards Board prior to his FASB appointment.

Li Li Lian, Staff member, IASB, 2006–2014; Worked for the International Federation of Accountants prior to her IASB appointment; Worked for Monitise and Moody's after her IASB appointment.

Thomas J. Linsmeier, Board member, FASB, since 2006; Professor of accounting at Michigan State prior to his FASB appointment.

Kristen Mathys, Staff member, FASB, 2008–09; Worked at Deloitte prior to her FASB appointment; Worked at KPMG after her FASB appointment.

Warren McGregor, Board member, IASB, 2001–11; Independent consultant prior to his IASB appointment; Consultant to the Australian Accounting Standards Board and to PricewaterhouseCoopers after his IASB appointment.

Patricia O'Malley, Board member, IASB, 2001–07; Staff member, IASB, 2007–09; Chair of the Canadian Accounting Standards Board prior to and after her IASB appointment.

Katherine A. Schipper, Board member, FASB, 2001–06; Professor of accounting at Duke prior to and after her FASB appointment.

Leslie F. Seidman, Board member, FASB, 2003–13; Board chair, FASB, 2010–13; Independent consultant prior to her FASB appointment; Worked for Pace University and board member for FINRA and Moody's after her FASB appointment.

Edward W. Trott, Board member, FASB, 1999–2007; Partner at KPMG prior to his FASB appointment.

David Tweedie, Board member and chair, IASB, 2001–11; Chairman of the U.K. Accounting Standards Board prior to his IASB appointment; President of the Institute of Chartered Accountants of Scotland and chairman of the International Valuation Standards Council after his IASB appointment.

Wayne Upton, Staff member, FASB, 1984–2001; Staff member, IASB, since 2001.

Donald M. Young, Board member, FASB, 2005–08; Independent consultant prior to his FASB appointment; Managing director at TomCat investments after his FASB appointment.

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