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ACCOUNTING THEORY & CONTEMPORARY ISSUES  
(AT I)  
MODULE TEN

STANDARD SETTING – POLITICAL ISSUES

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PART 1  -  Theories of Regulation

PART 2  -  Standard Setting in Canada

PART 3  -  International and U.S. Standard Setting

PART 4  -  An Ethical Perspective

PART 5  -  Conflict and Compromise

PART 6  -  Standard Setting Criteria and Conclusion

Lecture by:

Dr. A. L. Dartnell, FCGA

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Major Points:

Handout
Objective
Module Outline
Two Theories of Regulation

Objective

The question of regulation of accounting is not settled.

While a number of market incentives can bring forth private information production we do not know whether market failures can be reduced by limiting more regulation. Would it be more or less costly to society.

In this module we go back to the topics of conflict and conflict resolution which was introduced in Module 7. As we pointed out in Module 9 standard setting cannot be strictly an economic activity and this raises the question as to how it is achieved. As you will see the process is achieved primarily by the political process, where issues are settled primarily by due process, debate and compromise. Standard setting bodies appear to be structured in this manner.

We look at the ethical aspect of standard setting because where conflict exists ethical factors are certain to arise. Such a process would appear to bring successful results when reasonable compromise exists in arriving at viable solutions.

Information asymmetry exists, as noted previously, which results in moral hazard and adverse selection. This creates a demand for information.
Thus, the amount of information that would be privately produced would not likely equal what investors would want. Investors would then push for regulation to fill this gap.

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This suggests that standard-setting is as much, if not more, of a political process than an economic process.

As we saw earlier, **when the conflicting interests of the various constituencies involved cannot be rectified by contractual or market forces, there is an appeal to the political process.**

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**Module Outline**

*First* - we examine **two theories of regulation:**

**The public interest theory** view is that social welfare should be maximized. – the view in Module 9.

The **interest group theory** of regulation suggests that individuals form lobby groups or coalitions to protect their interests, and to lobby government. They are out to get the best for themselves.

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*Second,* our **objective** is to examine **standard-setting in Canada and the U.S.** It will be seen that these processes are largely consistent with the interest group theory of regulation.

*Third,* consideration is given to the **conflict in standard setting,** and compromise reached.

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*Fourth,* we consider **standard-setting from an ethical perspective.**

*Fifth,* **criteria that standard-setters should consider** if their standards are to be acceptable. While decision-usefulness and reduction of information asymmetry are necessary for any standard, there is more required. Standards must be acceptable to the constituencies, which requires care in the setting of standards.
Two Theories of Regulation

The Public Interest Theory was implicit in our examination of standard-setting. The theory suggests that regulation is required to answer the demand of the public for correction of market failures.

The theory assumes that the central authority has the best interests of the society as its objective. In other words it does its best to maximize social welfare. Then as you can understand the regulation is a tradeoff between the costs involved and the benefits received by society.

While it is ideal, it is difficult to put into effect. Some believe the theory is naive and lacks depth.

One of the main problems is trying to decide what the right amount of regulation is, which is particularly true for a commodity like information.

Further it is difficult for a legislative body, such as government, to know and control a regulatory agency. It is difficult for them to know how well the agency is performing as they do not know, for example, the right amount and content of information to be required. It is similar to our situation in game theory. A first-best contract may not be attainable because of implementation problems.

The Interest Group Theory takes the view that an industry operates in the situation where there are a number of interest groups (constituencies). We have many of these groups in our society - Manufacturers, Small Business, Environmentalists, Accounting, etc. They will lobby for their own needs and each one will have a different set of regulations they would like to see in place.

We have a recent example of strong lobbying in the Canada-U.S. softwood lumber dispute. The lobby group apparently was the driving force behind the U.S. stand on Canadian softwood.

These groups are referred to as "demanders of regulation."
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Further the political authority or legislature can be thought of as an interest group itself. Those who have power to supply the regulation.

Naturally they want to retain the power they have and so they will give regulation to the groups that will help them stay in power.

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This legislative group then is in the middle - it is the means by which regulation is supplied and it attempts to maximize its power by balancing the demands of the different constituencies. There are many instances in society.

The interest group theory takes the view that regulation is a commodity for which there is a demand and supply. The commodity will be supplied to those groups which are most politically effective in convincing the legislature to grant them regulatory favours.

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Probably the interest group theory is a better indicator of how regulation really works than is the public interest theory. See Sections 13.2 and 13.5 of your text for a discussion on this point.
PART 2

Standard Setting in Canada

Major Points:

The Standard-Setting Process in Canada
What is the Standard-Setting Process
The Process
Guidelines
Emerging Issues Committee
Ontario Securities Commission

The Standard-Setting Process in Canada

The Accounting Standards Board and the Auditing Standards Board are the two main committees of the Canadian Institute of Chartered Accountants which are responsible for the accounting and auditing standards, respectively. There is also a third committee referred to as the Public Sector Accounting and Auditing Committee.

These first two committees issue pronouncements (releases) which in the main make up the CICA Handbook. It has two volumes. There is a third volume for the public sector.

Legal status has been given to the CICA Handbook through the Canada Business Corporations Act, as companies subject to Federal law are required to conform to the standards.

This gives a good deal of recognition and power to the Handbook in both the Federal and Provincial jurisdictions.

Both committees are authorized by the Board of Governors of the Institute to issue pronouncements and be responsible for them. It appears from your module materials that you are responsible to know the terms of reference of the accounting committee but not the auditing committee. However, read about the auditing committee. It is good knowledge to have. There is also the Public Sector Accounting Advisory Committee which is not covered in the course.
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What is the Standard-Setting Process

The following points are important in the standard-setting process.

- The Accounting Standards Committee is composed of volunteer members, apart from a permanent chairman.

- The accounting committee publishes accounting standards on its own authority, as mentioned above. This gives independence and freedom from interference, at least in part.

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- New standards require that 2/3's of the voting members of the committee must approve for releases to be official. Your module materials point out that this is better than just a simple majority, because a marginal issue which is doubtful may pass with a simple majority. There has to be substantial support.

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- Two-thirds or more of the committee must be members of the CICA. This, of course, makes the 2/3's majority much less effective because an issue could pass strictly by the vote of CICA members.

- Members are chosen which represent both English and French, and they come from the different areas of the country. They are supposed to have different backgrounds and experience.

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- Members can be appointed from other areas such as business, financial analysts, credit grantors, etc. Five places are reserved for such appointments.

A note here – CGA could have one member on the committee but it has not appointed any one. One representative is rather limited. I understand the CMA’s do or could have a member.

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Your notes state that CICA has attempted to broaden representation on the committee by having members from outside. It is still very minimal.
Many think that there should be much more even representation of the three accounting bodies.

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**Process**

Exposure drafts are very important to the process of creating a new standard. These enable interested parties to react to the proposal of a new standard or a changed standard before it is finalized. As the project development process diagram shows, the process allows for change before final issuance as a standard.

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As stated above, there is only a permanent chair and the remaining members are voluntary. They are not full-time salaried positions. FASB in the U.S. has full-time paid positions. More comment is made on this below.

Topics arrive on their agenda from a variety of sources. They have the Standard Advisory Board, which would probably get a good many questions and problems to be resolved. Also, many other sources could submit ideas.

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A new standard requires considerable time.

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- Background research is needed.
- A project proposal is prepared and approved.
- A statement of principles follows, which describes the principles and premises of the proposal.
- Work then begins on the exposure draft, which is widely circulated to interested groups.
- After comments are received there could be a re-exposure draft.
- When completed, a release is issued, if a release is decided upon.

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This release must be followed if a company is to receive a clean bill of health from the auditor - unless for some reason the auditor can accept a diversion.
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Guidelines

Note, however, that the committee can issue guidelines. These are interpretations of existing Handbook recommendations or opinions on other matters for which a Handbook release does not exist.

Guidelines do not have the authority of the releases (recommendations) but they do carry considerable weight and they allow the CICA to react quickly if there is a need to.

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Emerging Issues Committee

The Emerging Issues Committee was established in 1988, for the purpose of the review of emerging accounting issues which may be receiving unsatisfactory accounting treatment in the absence of a standard. You can read about it in the article in the supplement.

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It is thought by some that the process to create a new standard is quite political.

Consultation then makes it political. If it were economic, then the accountants and economists could determine what it should be.

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Ontario Securities Commission

Your module notes deal with one securities commission - Ontario. Other provinces have securities commissions but probably Ontario is the most developed and could be considered a leader in its field.

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Role and Authority of the OSC

The authority of the OSC comes from the Securities Act of Ontario. According to the Act the Commission is required to lay down:
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- requirements for the timely, accurate and efficient disclosure of information;
- restrictions on fraudulent and unfair market practices and procedures; and,
- requirements for the maintenance of high standards of fitness and business conduct to ensure honest and responsible conduct by market participants.

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The Ontario Securities Commission regulates the largest stock exchange in the country - the Toronto Stock Exchange and the TSX Ventures Exchange, a venture capital exchange. They are both part of the overall Toronto Stock Exchange. The Commission is one of the most active commissions in the country.

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The OSC is comprised of 9 to 14 members, appointed by the Ontario Lieutenant Governor in Council for terms not exceeding 5 years. Its purpose is to protect investors from unfair, improper, and fraudulent practices, to foster fair and efficient capital markets, and to maintain public confidence in their integrity.

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OSC's relation with the CICA Handbook

It is very important for us as CGAs to know the OSC relates to our accounting standards. Under National Policy Statement 27 (1992) issuers of securities under the OSC jurisdiction must file financial statements in accordance with GAAP.

The OSC issues regulations on its own but apart from GAAP. Examples are MD &A. and requirements for the disclosure of executive compensation.
**PART 3**

**International and U.S. Standard Setting**

**Major Points:**

- The Financial Accounting Standards Board
- Standard-setting Process
- Typical Examination Questions
- International Accounting Standards

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**The Financial Accounting Standards Board**

*This is the major U.S. accounting standard-setting body.* It is separate from the accounting bodies. However, AICPA, the main accounting body in the U.S. is one of its sponsors.

Briefly, the relevant points are:

- It was established in 1973, and was preceded by the Accounting Principles Board.

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Its purpose is to establish and improve standards of financial accounting and reporting for the guidance and education of the public.

In pursuing its activities, **FASB is guided by certain principles:**

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- **Objectivity** in decision-making,
- **Consideration** of the **views of its constituents,**
- **Release of standards** only **when benefits exceed costs,**
- **Implementation of standards** in a way **which minimizes disruption of existing practice, and**
- **Review of past decisions** where necessary.
It is distinct and separate from the accounting bodies in the U.S.

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FASB is one of a three-part organization. The other two are the Financial Accounting Foundation (FAF) and the Financial Accounting Standards Advisory Council (FASAC).

FAF is responsible for the organization and it has representatives from three accounting bodies, financial analysts, financial executives, the securities industry and government.

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FAF is made up of 16 trustees, each of whom can serve no more than two consecutive three-year terms. See page 420 of the text for the makeup of FAF.

The Financial Accounting Standards Advisory Council is a large group appointed by FAF. Usually 35-40 members. The members have diversified backgrounds. Its purpose is to act as a liaison between FASB and the business and economic communities. It advises on proposals and FASB's preliminary position on issues.

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The composition of FASB is seven members, who are paid by FASB. Their background is important but their accounting knowledge, integrity, discipline, and judicial approach are very important.

They have no ties with any group or employer and are paid only by FASB.

Five out of seven must pass any new standards.

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Standard-setting Process

Briefly it is:

Any of the groups mentioned can evaluate a problem and it is brought to FASAC, which advises FASB on the importance and the urgency.

Preliminary evaluation of problems is undertaken by FASAC.
To be put on the agenda of FASB, an issue must be evaluated to determine:

- if it meets the criteria for admission, which includes that it must be significant
- it must be sufficiently controversial for resolving, and
- it must be something FASB is likely able to solve.

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**Early deliberations by FASB.** A more careful examination is undertaken.

**Tentative resolution.** The tentative conclusions of the Board. This represents a more formal description of the board members’ views and any consensus that may have developed. When consensus has been achieved FASB publishes documentation of its proposed solution, for example, an exposure draft.

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**Further Deliberations - exposure draft.** The exposure draft is circulated and three responses can occur:

- the project is terminated, or
- a re-exposure draft, or
- a final pronouncement.

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After issue **FASB periodically reviews** the release to determine if further action or any issue needs to be addressed.

FASB is privately funded, is not government, and is sponsored by several organizations. It is endorsed by governmental bodies such as the Securities and Exchange Commission, and the AICPA, the largest accounting body in the U.S.
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Typical Examination Questions

Question

When considering efficient market theory, standard setters in the financial accounting area face a dilemma. Why?

Answer

Because efficient market theory does not guide accounting policy choice.

Question

Back in 1993 FASB had a proposal that required accounting for stock-based compensation. What was proposed was that a measure of the cost of stock-based plans to be deducted in arriving at reported net income. The proposal drew wide criticism from industry and some government members. The chairman, Beresford, was expressing his views in an article pressing for the proposal to be adopted. (We covered this in Module 6 re stock options.)

a) The question asked whether the views were in accordance with the public interest theory or the interest group theory, and asked the student to explain why?

Answer

It was concluded they were more in accord with the public interest theory because he argued if financial accounting information is to be useful it must be neutral and that "it must report economic activity without colouring the message." He also stated that FASB must be evenhanded and thus give a faithful representation of the economic facts of a situation. These statements would imply the public interest theory.

b) The article suggests complete neutrality. However, it was asked of students - Given that net income, unlike speed or weight, does not exist as a well-defined economic construct, why is complete neutrality not attainable?
Answer

It is not attainable because there is no "true" net income except under ideal conditions. Thus it is impossible to measure income so that it will be completely evenhanded. The main reason is that different financial statement users have different needs, while they are all legitimate needs. While some would be in accord with measuring stock-based compensation as proposed by Beresford, the writer of the article, managers would strongly oppose such a move. Then whose interest would be served and whose would not be served. Is it evenhanded? Unless net income can be perfectly measured, which it cannot, it is difficult to argue that it can have a neutral effect.

c) Beresford in his article equates neutrality in measurement with decision-usefulness. Do you agree - Why or Why not?

Answer

Disagree: The decision-useful approach requires accountants to understand the decision problems of financial statement users so they will know what financial statement users need. To be useful such information should be useful and reliable.

However, FASB's SFAC2 defines reliable information as information that is verifiable and neutral where neutral means free of bias. Thus, neutrality is part of reliability.

Agree: However, SFAC2 refers only to reliability and not to relevance, and it is not correct to equate neutrality and decision-usefulness - neutrality is only part of the story. In effect, neutrality is a necessary condition for decision-usefulness, but it is not sufficient for decision-usefulness.

d) FASB announced public hearings on stock compensation. With which theory would public hearings be most consistent? Explain why you made your choice. If the information required by a new standard were completely neutral, would public hearings be necessary? Explain why or why not?

Answer

One can take either theory but it must be backed up by good consistent comments.

If the public interest theory, then public hearings may be a necessary part of determining what the public interest is, as different constituencies can explain their interests.

If the interest group theory, then public hearings are necessary to enable each group to present its views on the standard. The various groups are more likely to accept the standard as their views were heard.
If standard setting were completely neutral, that is, free of bias, hearings would not be necessary. Complete neutrality, if it were attainable, and likely not, would imply that FASB knows the new standard is fair to all constituencies. FASB could argue that the public hearings would introduce bias, depending on the group which was most effective in lobbying.

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**International Accounting Standards**

The founding countries of the IASC are shown on page 421 of the text as are the objectives of the organization. Go over them carefully.

Adopting of releases by the IASB (the International Accounting Standards Board) is voluntary. A growing number of countries conform to the international standard.

The IASC appoints 14 members, 12 of which are full-time positions. There are no geographic requirements for member appointments.

There is super-majority voting.

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**There is a body for security commissions around the world. It is The International Organization of Securities Commissions.** Canadian regulators are involved with it. The Commission recommends to its members that they use IASB standards.

The Securities and Exchange Commission in the U.S. accepts in some degree the idea of the IASB Standards but there are differences between IASB standards and FASB standards. See page 422. Another concern the U.S. has is enforcement.

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**The suggestion is made as to what might happen if all countries adopted IASB standards.** Some maintain that there would be race to the bottom, that is, countries would go to the lowest level in adhering to standards. However, that could backfire on countries who had become too careless about their standards.

The process does adhere to processes similar to those for setting standards in the U.S. and Canada. Due process is followed.
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Adoption of IASC Standards

The ultimate aim of the international group would be that all countries adopt the international standards and because of increased globalization it would have benefits, costs, consensus once agreed upon. There are over 100 countries which have adopted international standards.

This would have drawbacks also which are mentioned in the module notes under topic 10.2.

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An alternative to international standards would be if all countries accepted the FASB standards. This, of course, would give the U.S. a good deal of power and it is not likely countries would like that. Also with all the problems in the U.S. with companies it has tarnished the American standards a little.

Harmonization of the standards may well be the most appropriate goal at this stage, that is in general standards conform in the various countries and a little room left for changes which might be related to the particular countries involved.

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Some progress has been made toward harmonization. Three sections of the Handbook are mentioned – Section 1701, Segmenting; Section 3461, Post-employment Benefits; and Section 3861, Financial Instruments.

Despite the international scene, Canadian standard setting is in question at this point as one Accounting Body is setting the standards by which accountants have to work.

There is a call for much more independence and a more structured approach such as FASB and IASB.

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If Canada adopted FASB rules it would probably reduce our costs considerably. With such a large amount of trade over the border, this has its advantages. However, politically in Canada, this may not be a possibility.

Adoption of IASB standards may face fewer political objections in Canada.
As stated earlier there is a five year plan for Canada to adopt the International Standards and there will be no more Canadian GAAP.
PART 4

An Ethical Perspective

Major Points:

An Ethical Perspective in Standard Setting
The Process of Standard Setting and Ethics
Conflicts between Managers and the Investing Public

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An Ethical Perspective in Standard Setting

This is an important section. The need for ethics has become an important topic.

For this part you are required to read Units C1 and C3.

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It is likely that if there was no regulation, markets would cease to work. If such were the case then Hobbs (one of the writers in your ethical articles) argues that people would cooperate as this would be in their best interest. Hobbs suggests two motivations – the external motivation – the enforcement approach, a regulator (the “stick” approach), and the internal motivation, that people will want to keep their promises and honour contracts (the carrot approach). The outcome would quite likely be “what amount is required if regulation is needed?”

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The more ethically that people behave, the greater reduction there would be in required regulation.

One way to look at it would be, for example, if all professionals acted in their own self-interest, ignoring the clients’ recognition. In due course clients would become very suspicious. Regulations would grow and professionals would be very carefully scrutinized.
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However, if professionals can be trusted to act in a trustworthy way, then it could be a win-win situation. It goes beyond adopting a code of ethics. Professionals would have to act professionally towards the client. Professionals must become transparent in their actions so clients will have full trust in their actions. Certainly professionals have self-interest and this must be taken into account in a workable situation. One example would be that professionals receive comparable fees to the going situation in the community. If both sides are working together a good situation could be achieved and the regulation could be at a minimum.

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The Process of Standard Setting and Ethics

As some regulation would be required, what about standard setting from an ethical point of view.

First C1 points out the “marks of a profession.”

When accountants are dealing with clients there is very likely an imbalance of accounting knowledge between the two but accountants should not impose their own values on the client.

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Turning to the legal powers, we are concerned about one’s legal power relating to the development and promotion of policies relating to professional practice. This relates to standard setting in our case. Then from an ethical point of view, should a standard setting body follow the public interest theory or could the interest group theory be considered sufficiently ethical for standard setting purposes. The public interest theory considers the client (public) to be the centre. The interest group theory accords recognition to its own interest and those who support its interest.

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Professor Conrad Brunk argues that professionals cannot place in abeyance their convictions about the moral implications for society of the roles and institutions in which they function. Translated into our standard setting terms is that when there are accounting problems it does not mean we need a whole set of new standards but a conscientious application of the standards in effect. If after that there is a gap to be filled then it would seem one can consider the necessary standards.
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They give an example in the module notes of SFAS 115, the release aimed at ending gains trading. It is not that the release was a problem, it was that managers did not adhere to the requirements.

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Conflicts between Managers and the Investing Public

The standard setting bodies have an ethical issue because the standards set for clients, those who manage the companies, have a third dimension, as the managers’ interests often conflict with those of the public.

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Our case is the investing public, the third party. Now investors needs are well served by good disclosure of material. But we have seen in our previous modules that standards that are beneficial to the investor often impose burdens on the managers, e.g., the bonus limitations because of volatility of income and the debt covenant problems caused by such volatility.

Whose interests should the regulator serve?

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According to Duska and Duska, two researchers, the accountant and the regulator can easily reconcile the obligations by acting with integrity, that is, being honest about all activities towards the public, and, thus, the investor. In the long-run the interests of the public and the investor merge.

Your notes give the example, of Enron. It is suggested that the senior management at Enron managed earnings to increase the value of stock options and thus management compensation. The auditors agreed to this action. It appears that opportunistic earnings were allowed by the accounting standards at the time. It met the letter of the standards, that is, the wording, but not the intent (the spirit) of the standards. This was not in the interests of the client and the investors, but rather in the interests of the management. Management enjoyed large increases in compensation.
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It is important to consider the debate between what is termed “rules-based” and “principle-based” accounting standards. Considering Enron’s actions they were strictly based on rules actions of GAAP. They were not based on “principles” There is a difference. It was not in the interests of the public or the accounting profession. A rule is a group of words. The principle indicates the intent we have in mind and the course we follow. It is putting into effect the real ethics we wish to pursue. It appears that FASB is endeavouring to put into effect a more principled-based approach to accounting for financing reporting and standard setting.
PART 5

Conflict and Compromise

Major Points:

Conflict and Compromise
What about Marking-to-Market
Other Comprehensive Income

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Conflict and Compromise
SFAS115 - An Example of Constituency Conflict

This release by FASB, referred to earlier, relates to "Accounting for Certain Investments in Debt and Equity Securities." It is discussed here to show the conflict arising in its consideration and adoption.

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Very interesting. In 1992 FASB issued an exposure draft proposing at least some securities of firms be marked-to-market, which means fair value. This would imply market values are available on a reliable base. Otherwise present value would have to be used. It eventually led to SFAS 115.

You have seen some of the problems in previous modules. Our interest here is constituency conflict. If management had contentiously and ethically applied GAAP rules, there would have been no necessity to bring in SFAS 115.

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What about Marking-to-Market

As mentioned, the exposure draft specified that at least some securities held by firms be valued at fair value. This would envisage market value if reliable, and other means as determined by present value, use of models, or other techniques.
The FASB at one point had considered full marking-to-market, which would include all assets and liabilities, eliminate gains trading and make for volatility of income to the extent that it was not hedged between assets and liabilities.

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**Thus, full marking to market would eliminate a firm's ability to gains trade.** This is a form of earnings management under historical cost accounting, where management can selectively sell securities whose values have risen or fallen, in relation to the original cost, triggering a gain or loss at will.

**The banks objected because they hold large portfolios of financial assets and liabilities.** The volatility of their earnings would increase as their earnings management abilities would be eliminated.

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**Apparently the U.S. Treasury Board was concerned and strongly opposed the standard.** Its concern was for the banks because it felt the banks’ operating and financial strategies would be affected to the extent that they would be unwilling to lend long-term, and this would affect credit availability.

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**The proposal also faced technical difficulties.** It would be difficult to evaluate some liabilities of the banks, such as deposit liabilities. How much could depositors demand? What would deposits be worth with partial reserves backing deposits? Also, if the bank borrows for 1% and lends the deposit out for 5%, so long as the deposit remains as is, it is o.k. What if the deposit changes?

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However, if you eliminate financial liabilities and only deal with assets, **the natural hedging property** of the two would be eliminated making for greater volatility.

From another angle, the strong SEC supported the mark-to-market approach. They would want to convey fair value aspects to the investors.

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FASB was in a difficult position as it endeavoured to produce a generally acceptable standard. It was passed in 1993 and took effect for fiscal years starting after December 15, 1993.
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Some of the compromises made were:

Liabilities are excluded due to the measurement problem.

Some debt securities continue to be valued at cost, that is, lower-of-cost or market.

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It categorized securities into three classes:

- **held-to-maturity debt securities** are valued at amortized cost, which was previous practice;
- **trading securities** are valued at fair value, and unrealized gains and losses from trading securities are included in income;
- **available-for-sales securities** are valued at fair value, and unrealized gains and losses from those available-for-sale securities are included in other comprehensive income.

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Presumably these changes were made in the original exposure draft to meet management's objections. Gains trading has not been eliminated. Your writer suggests they may be encouraged to transfer longer-term securities to the temporary category. The held-to-maturity class has restrictions to try to eliminate the type of thing mentioned.

In any event it is hoped the increased disclosure will constrain gains trading and it is hoped SEC will agree to the changes. It appears they have.

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Other Comprehensive Income

This was spoken of earlier.

SFAS130 gives management a choice as to where to include other comprehensive income in the financial statements. Most logically it would seem this should be in the income statement, below net income. However, SFAS 130 allows a separate statement of changes in shareholders’ equity, which is probably favoured by management.
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The thinking would no doubt be that separating this component of income from net income would reduce volatility and market reaction to gains and losses. Not only gains and losses from marking-to-market are included but foreign currency gains and losses from consolidation of foreign subsidiaries are also included.

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The interests of management and investors can be reconciled if net income is calculated to maximize correlation with management effort and with other comprehensive income picking up other relevant gains and losses over which management has less control and relates only in small measure to management performance. SFAS 130 does not mention this aspect, however.

As stated on page 429, the split between realized and unrealized gains and losses indicates the two roles of these types of income to enable investors to evaluate managerial performance. As current market value is the best indicator of future value when markets work reasonably well, unrealized gains and losses provide relevant information to investors about future firm performance. However, to the extent that unrealized gains and losses are less informative about manager effort than are realized gains and losses, net income would seem to be the best performance measure for contracting. As a matter of fact, your course writer suggests that more items could be moved to other comprehensive income such as ceiling test writedowns, mentioned in Module 5, as these do not seem to relate to manager effort.

The conclusion is that there is a lack of decision-usefulness in other comprehensive income, thus, SFAS 130 seems to be a political compromise in order to assuage management in its view to providing income information. Management did not want unrealized gains and losses included in net income.

We come back to the former question, if markets are efficient does it make much difference where it is reported, so long as it is disclosed? Net income is current and other comprehensive income is future.

There is a similar requirement in Canada which was effective October 1, 2006, it is under Section 1530.
PART 6

Standard Setting Criteria and Conclusion

Major Points:

Criteria for Standard Setting
Course Conclusion

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Criteria for Standard Setting

There are various factors which affect standard-setting

Standards should be useful and should be acceptable to the constituencies involved, particularly management. This is a very conflict ridden situation and puts the standard-setters in a difficult position.

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There are four criteria which should be considered, and which are very important.

- the first two are oriented to investors,

- the third is oriented to managers, and

- the fourth to a more general point of view and it emanates from the first three.

Slide 93

Decision-usefulness

Our First Point relates to Decision information: Is important to the investor. The stronger the system, the more investors will respond as investors find information useful.

A new standard should be decision-useful. It is difficult to assess but not impossible.
Decision-useful is essential but not sufficient in itself to ensure success. While a standard may be useful to a good many people who do not pay for it, and socially desirable, the cost involved and who pays is important.

**Slide 94**

**Reduction of information asymmetry**

Our Second Point relates to Information Asymmetry. Market forces operate to motivate managers and investors to generate information. Setters of standards should note these forces and use them whenever possible to reduce the need for standards.

Market forces alone cannot ensure the right amount of information. A major reason being information asymmetry and this should be the objective in standard-setting. Reduction of information asymmetry will improve markets.

**Slide 95**

Standard-setters should be aware of the informativeness of price itself as a conveyer of information. The efficient market price of a firm's shares reflect, with noise, what is publicly known about the firm. The larger firms do not have as much noise as do the smaller ones as there is more known about the larger firms. Thus, standard-setters should be aware of the noise, especially re smaller firms.

While reduction of information asymmetry is important, it is not the only criterion to be watched.

**Slide 96**

**Economic consequences of new standards**

Our Third Point relates to Economic Consequences. All costs of new standards, both interior and exterior, should be considered. A number of good items for consideration are shown in your text page 433.

Standard setters should weigh the possible economic consequences of new standards as this will affect the "willingness" of management to accept the standard. Caution: sometimes they may be overstated by management. However, such things as costs to implement a new standard should be considered, costs resulting from contract rigidities. For example, volatility may result income from the effects of a standard and this could be related to debt violation and managers’ bonuses.
Others are the requirement to release proprietary information and reduction of the firm’s ability to compete, thus affecting profitability. Further the ability to choose accounting policies is an important factor. For example, a little earnings management may be needed by a firm. If a standard makes for more uniformity there is a lower ability for diversity of approach.

The text suggests the finding of one study was that the greater the competition in an industry, the greater the disclosure which takes place; thus, the greater need for standards in some industries than others.

**Slide 97**

**The Political aspects of standard-setting**

**Fourth - Standard-setters must come up with a standard which all constituencies will accept even though to a different degree - a consensus.** The process has to take the various views into account. It cannot just determine the economics of a standard, it must take into account the political ramifications.

**Slide 98**

**A review of what is mentioned above indicates clearly the interest group theory.**

Sound economic standards do not ensure success as there can be strong reaction from management.

It is a very political - economic process. As two writers in a study pointed out that a standard setting body has to tread carefully in setting standards.

**Slide 99**

**Course Conclusion**

The whole course comes to rest on the political aspects of standard setting.

In Module one, under ideal conditions, present value is the way to go. However, that is not life, and uncertainty and information asymmetry come into the picture.
Slide 100

Two types of information asymmetry are adverse selection and moral hazard.

An accounting system for the first one - adverse selection - requires that inside information be conveyed outwardly. This requires extensive decision-relevant material.

The second situation moral hazard requires information for contracts that are measures of performance, etc., which correlate with management’s efforts. Volatility is not an attribute that is helpful in this task. Smoothing of income is more important.

Slide 101

Volatility of income may be good for decisions but not for measuring performance. These two types of accounting do not have the same objective and decision-useful information may work against performance measures. Volatility of income may be good for decisions but not for measuring performance.

Slide 102

We need accounting which will fill the dual role. Different constituencies want information for different purposes. The increased globalization brings another dimension into the picture.

In summary, the standard-setter must be a good creator of compromise. He/she must be wise, patient, and understanding and keep an eye on the goal.