

ACCOUNTING FOR FASB: WHY ADMINISTRATIVE
LAW SHOULD APPLY TO THE FINANCIAL
ACCOUNTING STANDARDS BOARD

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I. INTRODUCTION

Who knew accounting could be so contentious? For all the jokes about the boring lives and personalities housed within the accounting profession,¹ the work product and the promulgation of accounting standards has had a long history of brutal infighting just as entertaining, if not more so, than any professional wrestling event.² But this should not be such a surprise. Accounting standards are housed under a complex regulatory system³ and compliance with these standards is by way of an intense enforcement apparatus.⁴ Such a governance system would not be built around an area of low stakes. Indeed, accounting standards have strong behavioral effects on business managers and broad economic consequences.⁵ Because public companies are required to use Generally Accepted Accounting Principles (GAAP) when compiling financial statements,⁶ accounting standards have become more important with a steady increase in worldwide ownership interest in public companies.⁷

1. “When does a person decide to become an accountant? When he realizes he doesn’t have the charisma to succeed as an undertaker.” *Reading Room: Humor*, GREENSTEIN, ROGOFF, OLSEN & CO., LLP, CPA’S, <http://www.groco.com/readingroom/humor.aspx> (last visited April 15, 2011).

2. The assumption that professional wrestling is entertaining is based on the steady increase in net revenues of World Wrestling Entertainment, Inc. Net revenue of close to \$500 million in 2009 is almost double the \$260 million net revenue of 2006. WORLD WRESTLING ENTERTAINMENT, 2009 ANNUAL REPORT: STRENGTH IN NUMBERS 23 (2010), available at http://corporate.wwe.com/documents/annual_report_2009/HTML2/wwe-ar2009_0025.htm.

3. See, Richard H. Pildes, *Separation of Powers, Independent Agencies, and Financial Regulation: The Case of the Sarbanes-Oxley Act*, 5 N.Y.U. J. L. & BUS. 485, 493 (2009) (describing the array of institutional arrangements—including self-regulatory bodies, mixed public-private governance structures, and direct SEC regulation—relied on to ensure investor confidence in the integrity of U.S. markets).

4. See Lawrence A. Cunningham, *The SEC’s Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. REV. 1, 43 (2008) (listing accounting enforcement as including “the SEC, private litigation, and various other state and federal authorities”).

5. See David I. Walker, *Financial Accounting and Corporate Behavior*, 64 WASH. & LEE L. REV. 927, 945 (2007) (stating that positive accounting theory posits that managers of firms with earnings-based bonuses favor accounting standards that tend to increase earnings).

6. Securities Exchange Act of 1934, 15 U.S.C. § 78m(b) (2006).

7. See Paul Volcker, Remarks to the World Congress of Accountants: Accounting, Accountants, and Accountability in an Integrated World Economy 1

Consider the array of areas touched by GAAP. Private contracts will often include covenants based on financial performance or financial ratios that are produced in compliance with GAAP.⁸ Some important parts of tax policy are linked to GAAP.⁹ Further, enforcement of some securities laws are intertwined with GAAP.¹⁰ In fact, empirical studies have shown that changes in GAAP have the potential to impact share prices broadly.¹¹ Such a broad impact should leave no question that there a variety of interests at stake when we talk about control over the promulgation and enforcement of accounting standards.

Enter in the Sarbanes-Oxley Act of 2002 (SOX).¹² SOX was passed by Congress in reaction to the wave of accounting scandals that surfaced in the early part of the decade.¹³ Accounting shenanigans discovered at companies such as Enron, Worldcom, and Tyco led Congress to decide it was time to make changes to the structure of accounting standard enforcement and promulgation.¹⁴ The passage of SOX led to increased oversight of internal control procedures and increased financial statement mandates on business managers of public companies.¹⁵ Not long after its passage, a survey conducted showed that the majority of CEOs of the largest companies in the United States wanted to repeal the

(Nov. 19, 2002), available at <http://www.iasplus.com/resource/volcker0211.pdf> (stating that accounting standards must be strengthened in the global economy).

8. See Walker, *supra* note 5, at 941 (noting the impact of GAAP accounting when tied into corporate debt covenants).

9. Cunningham, *supra* note 4, at 34.

10. *Id.*

11. See, e.g., Hassan Espahbodi et al., *Impact on Equity Prices of Pronouncements Related to Nonpension Postretirement Benefits*, 14 J. ACCT. & ECON. 323, 340–41 (1991) (finding that the release of a proposal to change accounting standards regarding postretirement health benefits from pay as you go to accrual accounting resulted in a 3% share price reduction for firms in a sample group).

12. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

13. See Michael A. Thomason, *Auditing the PCAOB: A Test to the Accountability of the Uniquely Structured Regulator of Accountants*, 62 VAND. L. REV. 1953, 1954–55 (2009) (describing how after several highly publicized corporate accounting scandals, Congress passed SOX which represented “a radical departure from the previously self-regulated accounting profession”).

14. *Id.*

15. Michael A. Carvin et al., *Massive, Unchecked Power by Design: The Unconstitutional Exercise of Executive Authority by the Public Company Accounting Oversight Board*, 4 N.Y.U. J. L. & BUS. 199, 210 (2007).

Act.¹⁶ Many criticize Congress for acting hastily in the wake of accounting scandals¹⁷ and claim that the alleged benefits of SOX do not outweigh its costs.¹⁸ The SOX backlash has resulted in a broad movement against changes to accounting standards that has been brooding for almost a decade.¹⁹

The intense dislike for SOX bubbled over into the first major attack—a challenge to one of the centerpieces of the act, the Public Company Accounting Oversight Board (PCAOB).²⁰ The PCAOB was given vast power to create and enforce auditing standards for public accounting firms.²¹ The PCAOB can initiate investigations of accounting firms, report whether the firm is in compliance with provisions of SOX, and grant sanctions for firms that are not in compliance.²² These powers have caused consternation among public accounting firms who previously were self policed and accountable only to General Auditing Standards (GAS). After receiving a negative report, one accounting firm finally filed suit to test the legality of the PCAOB.²³ The challenge in *Free Enterprise Fund v. Public Company Accounting Oversight Board*²⁴ focused on the constitutionality of the appointment process for board

16. See HENRY N. BUTLER & LARRY E. RIBSTEIN, *THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT* 86 (2006) (reporting that 58% of corporate directors in the United States surveyed favor repealing or overhauling SOX).

17. Andrew A. Lundgren, *Sarbanes-Oxley, Then Disney: The Post-Scandal Corporate-Governance Plot Thickens*, 8 DEL. L. REV. 195, 199–200 (2006).

18. See Kate O'Sullivan, *The Case for Clarity*, CFO Magazine (Sep. 1, 2006), http://www.cfo.com/article.cfm/7851741/c_7873404?f=magazine_featured (last visited March 22, 2011) (“As a result, more than 8 in 10 say the benefit of [SOX] does not outweigh the cost.”).

19. See Caroline Harrington, Note, *Attorney Gatekeeper Duties in an Increasingly Complex World: Revisiting the “Noisy Withdrawal” Proposal of SEC Rule 205*, 22 GEO. J. LEGAL ETHICS 893, 896–900 (describing reactions by business to enforcement of SOX requirements by the SEC).

20. See generally, *Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, 537 F.3d 667 (D.C. Cir. 2008) (regarding an attack on the constitutionality of the PCAOB).

21. *Id.* at 205.

22. *Id.* at 205–06.

23. See Michael R. Keefe, Case Note, *The Constitutionality of the Double For-Cause Removal Restriction: Free Enterprise Fund v. Public Company Accounting Oversight Board*, 537 F.3d 667 (D.C. Cir. 2008), 77 U. CIN. L. REV. 1653, 1653–54 (2009) (explaining that, after a routine inspection of the Nevada accounting firm Beckstead & Watts LLP, the PCAOB identified numerous discrepancies in the firm's accounting practices which prompted Beckstead to sue in federal district court rather than appeal to the SEC).

24. 130 S. Ct. 3138 (2010).

members; the challengers claimed that in Congress's zeal to create an independent board, it gave the PCAOB vast power with no accountability to an elected official.²⁵ To strike down the PCAOB and the rules it enforced, the accounting firm argued that separation of powers was violated because neither the President nor a proper subordinate had adequate control over the operations of the PCAOB.²⁶ Because PCAOB members can only be removed for cause by SEC directors, and SEC directors can only be removed for cause by the President, the "double for-cause removal" procedure limits the President's ability to control the operations of the PCAOB.²⁷ Both the district court and circuit court that heard the case agreed that separation of powers was not violated by the double for-cause removal setup.²⁸ The Supreme Court disagreed, yet did not go as far as ruling all of SOX unconstitutional or imposing an injunction on the PCAOB.²⁹

The challenge to the legality of the PCAOB is likely the first of many assaults on the provisions of SOX. The basis of this Note is to examine potential challenges to the Financial Accounting Standards Board (FASB). Unlike the PCAOB, FASB was not created by SOX. Rather, it has been in existence since the mid-70s. FASB is the organization that promulgates accounting standards known as GAAP.³⁰ Before SOX, FASB's role as standard setter was based entirely off of recognition by the SEC as the authoritative body on GAAP.³¹ SOX solidified this role in legislation.³² In doing so, FASB now more than ever is open to legal challenges based on its status as a quasi-agency.

FASB has not been without its share of controversy in the past. This can be understood because as the body that maintains GAAP, where FASB intervenes, it does so in high

25. Attorneys for the plaintiff in *Free Enterprise Fund* describe this lack of supervision as the chief concern in the challenge against the PCAOB. See generally Carvin, *supra* note 15.

26. See Keefe, *supra* note 23, at 1664–67.

27. *Free Enterprise Fund*, 130 S. Ct. at 3147.

28. *Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, 537 F.3d 667, 685 (D.C. Cir. 2008).

29. *Free Enterprise Fund*, 130 S. Ct. at 3161–62.

30. See *infra* Part II.

31. *Id.*

32. *Id.*

stakes territory.³³ In fact, FASB standards often provoke much controversy.³⁴ At the start of its operations in the 1970s, FASB immediately found itself in the middle of controversy when it proposed a trio of accounting changes designed to limit corporate managers' ability to smooth earnings across accounting periods.³⁵ In the 1980s, FASB did little to endear itself to managers when it proposed that obligations to retired employees under a defined benefit pension plan should be booked liabilities.³⁶ Most recently, FASB found itself again in the middle of controversy with proposed changes to stock option expensing.³⁷

Today, FASB continues to stir up controversy. Recently, FASB has begun the process to revise lease accounting and do away with the distinction of capital and operating leases.³⁸ This change would on average result in higher debt levels on a company's balance sheet because companies would no longer be able to avoid recognizing the long term impact of lease payments. Corporate directors have already balked at this proposal and insist that such a change would have a major negative impact on financial statements. Additionally, FASB has trended to move accounting standards toward fair value accounting as opposed to historic cost accounting.³⁹ This switch would result in companies having to revalue assets and liabilities on a regular basis and adjust balance sheet accounts to conform to market values. The impact of this switch is that firm's financials will be exposed to risk of increase liability amounts and decreased asset values. Corporate directors looking to keep financial statement results consistent are

33. William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5, 7 (2007).

34. Often this controversy is a result of corporate managers campaigning against FASB standards. Cunningham, *supra* note 4, 64.

35. See Bratton, *supra* note 33 (describing that FASB made changes to recognition of loss contingencies, forced more write-downs of trouble loans, and limited asset capitalization in the oil and gas industry).

36. Resistance to this proposed change was successful as FASB rescinded the proposal after receiving comments. *Id.* at 33.

37. This particular controversy is discussed in much more detail in Part III.

38. See FINANCIAL ACCOUNTING STANDARDS BOARD, FINANCIAL ACCOUNTING SERIES DISCUSSION PAPER, NO. 1690-100, LEASES: PRELIMINARY VIEWS (2009).

39. See Stanley Siegel, *The Coming Revolution in Accounting: The Emergence of Fair Value as the Fundamental Principle of GAAP*, 42 WAYNE L. REV. 1839, 1840-41 (1996) (describing the trend towards fair value accounting over the latter part of the twentieth century).

opposed to the change.⁴⁰ In all, FASB has provided corporate directors across the country with the motivation to challenge the legality of its accounting standards, and SOX has given more ammo to these directors on which to attack FASB.

To those wishing to challenge FASB, there are a variety of tools available. Lobbying Congress to pass legislation revising GAAP, applying pressure to the SEC to issue regulations revising FASB pronouncements, and direct suits to accounting standards have always been available methods.⁴¹ However, what is not often discussed is the use of administrative law doctrines to challenge both the status of FASB as well as the standards it promulgates. Whether the Administrative Procedure Act (APA) and other administrative law tools apply to FASB has received only minimal treatment in legal scholarship.⁴² This could be for a variety of reasons, including statements by the SEC itself that FASB is not an agency.⁴³ Even the language of SOX supports this claim by calling FASB a private organization.⁴⁴ What is most surprising is the seemingly wide-spread acceptance this claim has had with minimal push-back. The PCAOB is also said to be a private organization.⁴⁵ In *Free Enterprise Fund* both the circuit court and the Supreme Court paid very little attention to this possibility, and even attorneys for the plaintiff seem to accept this notion.⁴⁶ Commentators on the subject have also seemed to acquiesce to this idea easily.⁴⁷ In fact, there has only been a single

40. See Bratton, *supra* note 33, at 32 (describing fair value accounting as anathema to corporate managers).

41. See *infra* Part III.

42. See, e.g. HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 153 (1979) (maintaining that “[t]he determination of what accounting should mean” is too important to be left to a nonagency entity).

43. Speaking at an investor’s rights conference, former SEC chair David Ruder stated, “The FASB is a private organization, not an independent government agency, and is not subject to the Administrative Procedure Act and other legislation applicable to government agencies.” David S. Ruder, *Balancing Investor Protection with Capital Formation Needs After the SEC Chamber of Commerce Case*, 26 PACE L. REV. 39, 64 (2005).

44. See *infra* note 86 and accompanying text.

45. See Carvin, *supra* note 15, at 204 (noting that Congress made the PCAOB a private, nonprofit corporation).

46. See *id.* (accepting that the PCAOB is not “treated as a governmental entity under a wide range of federal statutes, such as the Administrative Procedure Act”).

47. See, e.g., Kimberly N. Brown, *Presidential Control of the Elite “Non-Agency”*, 88 N.C. L. REV. 71, 74 (2009) (“The [PCAOB] sets its own budget and is exempt

challenge to FASB on the basis that it is subject to federal agency requirements.⁴⁸ However, rather than resolve the case on its merits, the court dismissed the suit because the plaintiff lacked standing.⁴⁹

However, the new wrinkle in this claim is SOX itself. Prior to SOX, the accounting industry was not subject to coordinated government regulation.⁵⁰ Indeed, SOX is the first instance of explicit authorization to the SEC to subdelegate authority for creating accounting standards.⁵¹ Additionally, FASB has set itself up as an independent agency in order to gain credibility.⁵² The actions taken by FASB combined with Congress's formal recognition of the SEC's subdelegation combine to provide the basis for administrative law challenges on FASB.

This Note will proceed in parts. In part II, I offer an overview of the history of accounting standard promulgation starting from the Securities Act of 1933 to today. In part III, I list the mechanisms available to corporate directors to challenge FASB promulgations and explain why administrative law challenges are the most likely to succeed. In part IV, I detail why FASB should be considered an agency based on how it is treated by the branches of government, the subdelegation of authority, its own internal operations, and the effect of SOX. In part V, I discuss the ramifications of recognizing FASB as a federal agency subject to the APA and other administrative law doctrine. Finally, I conclude with a short discussion on the implications for the financial sector of such recognition.

from the procedural and judicial review strictures of the [APA]”).

48. *Arthur Andersen & Co. v. Sec. & Exch. Comm'n*, Fed. Sec. L. Rep. ¶ 95,720 (N.D. Ill. 1976).

49. *Id.*

50. Prior to the creation of the PCAOB, firms were regulated by “a bewildering array of monitoring groups’ under the auspices of the accounting profession.” S. REP. NO. 10-205, at 4 (2002).

51. Jacob L. Barney, *Beyond Economics: The U.S. Recognition of International Financial Reporting Standards as an International Subdelegation of the SEC's Rulemaking Authority*, 42 VAND. J. TRANSNAT'L L. 579, 586 (2009).

52. See Bratton, *supra* note 33, at 9 (describing FASB as lacking credibility until adopting procedures resembling agency directives).

II. DEVELOPMENT OF INSTITUTIONALIZED ACCOUNTING STANDARDS

A. History

The development of accounting standards setting is an interesting one, mired in trial and error. The idea that standard setting can be institutionalized is relatively new. Throughout most of history, accounting standards have been a product of self-regulation.⁵³ This tradition of self-regulation was born out of common law countries, which mostly left business standards to the profession.⁵⁴ Thus, the self-regulation model for accountants was more a product of history than an actual policy determination.

In the United States, institutionalized standard setting first came into existence after passage of federal securities laws in the 1930s that directed the SEC to determine the form and content of financial statements.⁵⁵ For several years, the SEC opined on the best course of action until deciding to completely delegate the job of developing accounting standards to the accountants' professional organization, the American Institute of Accountants (AIA) (currently known as the American Institute of Certified Public Accountants, or AICPA).⁵⁶ The AIA created the Committee on Accounting Procedure (CAP) to serve as the standard-setting arm of the organization.⁵⁷ However, CAP had a muddled mission: rather than set new standards, the group was to draw from the profession's prevailing practices and recommend appropriate standards.⁵⁸ This ad hoc approach was not well received by the profession, and in 1959, the AICPA created a new committee, the Accounting Principles Board (APB).⁵⁹ However, the APB did not last long either. The APB would come to be seen by the profession as unable to keep up with the increased technical

53. Cunningham, *supra* note 4, at 41.

54. *Id.*

55. *E.g.*, Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74.

56. Stephen A. Zeff, *A Perspective on the U.S. Public/Private-Sector Approach to the Regulation of Financial Reporting*, ACCT. HORIZONS, Mar. 1995, at 52, 54-57.

57. Barney, *supra* note 51, at 586.

58. ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 7 (1994).

59. *Id.*

issues facing the industry.⁶⁰ Additionally, controversy surrounded the APB both because of standards promulgated⁶¹ and because of the perception that the APB was dominated by large accounting firms.⁶² In time, the APB's inability to promulgate standards governing merger activities frustrated even the large accounting firms.⁶³

A conference of auditors, preparers, and financial statement users was convened in 1971 by the AICPA to discuss the next steps in accounting standard development.⁶⁴ A study group was appointed that recommended a new standard setter be created with a focus on independence but also better constituent representation.⁶⁵ In 1973, these private negotiations by the accounting profession resulted in the creation of the third iteration of institutionalized standard setting—FASB.⁶⁶ The SEC quickly recognized FASB as the new authorized accounting standard setter.⁶⁷

B. Structure of FASB

To further the independence goal, FASB was organized under the direction of the Financial Accounting Foundation (FAF).⁶⁸ The FAF was the original body designated as the successor to the APB; the FAF in turn delegated authority to promulgate accounting standards to FASB.⁶⁹ The FAF was organized as an independent not-for-profit entity and comprised nine trustees who were representatives of accounting standard stakeholders—auditors, preparers,

60. *Id.*

61. *Id.* at 57–59.

62. Bratton, *supra* note 33, at 12–13.

63. Ronald King & Gregory Waymire, *Accounting Standard-Setting Institutions and the Governance on Incomplete Contracts*, 9 J. ACCT. AUDITING & FIN. 579, 585–86 (1994).

64. *Id.*

65. *Id.*

66. Dennis K. Beresford, *How Should the FASB be Judged?*, ACCT. HORIZONS, June 1995, at 56, 58.

67. Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,172 (Dec. 20, 1973).

68. *Overview*, FIN. ACCOUNTING FOUND., <http://www.accountingfoundation.org/cs/ContentServer?site=Foundation&c=Page&pagename=Foundation%2FPage%2FFAFSectionPage&cid=1176158231339> (last visited April 15, 2011).

69. Bratton, *supra* note 33, at 14.

financial statement users, and academics.⁷⁰ The FAF was made responsible for appointing the full-time seven member FASB, a number that enabled FASB to work more quickly than the part-time, twenty-one member APB.⁷¹

FASB members were expected to cut connections with employers, divest investments, and go on salary for a five-year term.⁷² Four of the seven members were required to be CPAs, with the others required to be “well versed in problems of financial reporting.”⁷³ The premise of the entire operation was to promote independence in the hopes that this would ground decisions in objective data.⁷⁴ This was taken so far as to set up FASB offices in Connecticut as opposed to New York or Washington, D.C.⁷⁵ FASB continues to operate under this structure with the biggest change being an expansion of the FAF to nineteen members appointed by eight constituent organizations: 1) the American Accounting Association; 2) the AICPA; 3) the Chartered Financial Analysts Institute; 4) Financial Executives International; 5) the Government Finance Officers Association; 6) the Institute of Management Accountants; 7) the National Association of State Auditors, Comptrollers, and Treasurers; and 8) the Securities Industry and Financial Markets Association.⁷⁶

C. SOX Reform

In the wake of shaken public confidence in the financial sector due to massive accounting scandals, Congress quickly reacted by passing SOX.⁷⁷ The Act did many things, but the overarching theme was to create independence for

70. Van Riper, *supra* note 58, at 9.

71. Bratton, *supra* note 33, at 15.

72. Van Riper, *supra* note 58, at 17.

73. ROBERT CHATOV, CORPORATE FINANCIAL REPORTING: PUBLIC OR PRIVATE CONTROL?, 234 (1975).

74. See Brown, *supra* note 47, at 80 (describing that the belief behind structuring agencies in an independent form “facilitates logical decision making grounded in objective data and science”).

75. Van Riper, *supra* note 58, at 13.

76. Andreas M. Fleckner, *FASB and IASB: Dependence Despite Independence*, 3 VA. L. & BUS. REV. 275, 280 (2008).

77. Michael A. Thomason, Jr., *Auditing the PCAOB: A Test to the Accountability of the Uniquely Structured Regulator of Accountants*, 62 VAND. L. REV. 1953, 1955 (2009).

accounting standard setters.⁷⁸ When first introduced in the House by Representative Oxley, the bill was extremely vague and left the structure of a new accounting standard-setting model to SEC discretion.⁷⁹ This initial version was not well received, but Senator Sarbanes would soon after introduce a bill closer to the final SOX product.⁸⁰ Throughout the hearings, legislators would repeatedly hear testimony about the inadequacies of the self-regulation model in place at the time of the accounting scandals. Many legislators commented that such a model was unsustainable and advocated for a stronger authority with power to promulgate accounting standards and police the accounting profession. Though the idea for more authoritative control of accounting standards had both supporters and critics, most agreed that whatever body was produced should be independent from pressure by the accounting profession as well as Congress.⁸¹

By any standards, the speed with which SOX was passed was overwhelming.⁸² Yet the Act enjoyed overwhelming support from members of Congress as well as the President.⁸³ With the signing of SOX, Congress had for the first time explicitly granted statutory authorization for the SEC to subdelegate accounting rulemaking authority despite the tradition of doing so since 1938.⁸⁴ It did so by amending Section 19 of the Securities Exchange of 1933 to allow the SEC to subdelegate rulemaking authority by “recognize[ing], as ‘generally accepted’ for purposes of the securities laws, any accounting principles established by a standard setting body” that meets certain criteria.⁸⁵ The Act requires that the standard-setting body:

- i. is organized as a private entity;

78. See Keefe, *supra* note 23, at 1669–71 (describing the variety of provisions within SOX designed to make the PCAOB an independent entity).

79. Pildes, *supra* note 3, at 498–99.

80. *Id.* at 499.

81. *Id.* at 504.

82. The House passed its initial version in April 2002; the Senate passed its in June 2002. The two were reconciled within two weeks, and President George W. Bush signed SOX into law in July 2002. Carvin, *supra* note 15, at 202.

83. *Id.*

84. Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 987 (2005).

85. Sarbanes-Oxley Act of 2002 § 108, 15 U.S.C. § 7218 (2006).

- ii. has, for administrative and operational purposes, a board of trustees (or equivalent body) serving in the public interest, the majority of whom are not, concurrent with their service on such board, and have not been during the 2-year period preceding such service, associated persons of any registered public accounting firm;
 - iii. is funded as provided in section 109 of the Sarbanes-Oxley Act of 2002;
 - iv. has adopted procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices; and
 - v. considers, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors; and
- B. that the Commission determines has the capacity to assist the Commission in fulfilling the requirements of subsection (a) and section 13(b) of the Securities Exchange Act of 1934, because, at a minimum, the standard setting body is capable of improving the accuracy and effectiveness of financial reporting and the protection of investors under the securities laws.⁸⁶

Included in this language is a cross reference to the funding mechanism established for the PCAOB: public companies are required to pay “annual accounting support fees” to fund operations of the recognized boards.⁸⁷ After passage of SOX, FASB applied for recognition by the SEC, which was promptly granted.⁸⁸

86. 15 U.S.C. § 77s(b)(1)(A)(i)-(v), (b)(1)(B) (2006).

87. 15 U.S.C.A. § 7219(c)(1) (West 2011).

88. Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 8221, Exchange Act Release No. 47743, Investment Company Act Release No. 26028, 68 Fed. Reg. 23,333, 23,333 (May 1, 2003).

III. AVAILABLE TOOLS TO CHALLENGE FASB STANDARDS

Those wishing to challenge FASB standards are not without tools currently. A variety of mechanisms are available to potentially trump or revise accounting standards promulgated by FASB. However, for reasons detailed below, these available mechanisms are either substantively ineffective or unrealistic. This reality is what warrants a detailed analysis of how administrative law can apply to FASB; otherwise, no meaningful oversight of accounting standard promulgation exists.

A. Override FASB Standards by Statute

Perhaps the most powerful way to defeat any FASB standard is to go to Congress, which has the power to override any accounting standard promulgated by FASB by passing legislation and has been pressed to use this weapon in the past.⁸⁹ At times in FASB's history, Congress itself threatened to use legislation in order to stop a controversial accounting standard. Amid the energy crisis of the 1970s, Congress balked at attempts to change accounting rules for the oil and gas industry.⁹⁰ In the 1990s, Congress threatened to shut FASB down if it changed accounting rules for stock options.⁹¹

However, even though Congressional intervention is the most powerful tool, Congress is rarely persuaded by business lobbyists to carry out these threats.⁹² Only two clear examples are available. In one instance, Congress passed an investment tax credit aimed at providing immediate benefits for asset purchases.⁹³ Rather than allow FASB to determine whether the benefit should be recognized in financial statements over the life of the asset or all at once, Congress, due to heavy lobbying by business leaders, specified in legislation that either approach would be

89. See Walker, *supra* note 5, at 1000–03 (describing instances of involvement by Congress in the accounting standards setting process).

90. See Cunningham, *supra* note 4, at 64 (describing accounting for exploration costs and reserves in the oil and gas industry as a “life-threatening” debate for FASB).

91. *Id.*

92. Walker, *supra* note 5, at 1002.

93. *Id.*

acceptable.⁹⁴ In the second, FASB proposals to change stock option expensing in the 1990s was met by a Senate bill that would have conditioned effectiveness of any new standard on an SEC majority vote.⁹⁵ As a result, FASB tabled the proposal.⁹⁶

Other than these two examples, Congress's successful intervention into accounting standards is limited to reactions to financial crises. The first example was the collapse of the stock market in the late 1920s that resulted in creating the SEC to, in part, promulgate accounting standards. The second was the passage of SOX in the wake of accounting scandals in 2001.⁹⁷ There are a number of reasons for this. First, Congress, itself, recognized the importance of having an independent organization promulgating accounting standards. In fact, one of the main goals of SOX was to create a regulatory model with fewer opportunities for congressional interference.⁹⁸ Second, advocates for FASB will often remind Congress of the importance of independence when Congress does attempt to intervene. In the latest fight regarding stock option expensing, the FAF responded swiftly and harshly to attempts by Congress to block FASB proposals.⁹⁹ This was a huge difference from the 1990s when Congress essentially bullied FASB into tabling its proposal. The result of the FAF's advocacy on behalf of FASB was a successful change to accounting standards regarding stock options, a fight that took nearly twenty years.¹⁰⁰

B. SEC Intervention

Similar to Congress, the SEC also has the power to override FASB actions. Because the SEC is the organization with direct responsibility to promulgate accounting

94. *Id.*

95. Beresford, *supra* note 66, at 57.

96. Michael H. Granof & Stephen A. Zeff, *Unaccountable in Washington*, N.Y. TIMES, Jan. 23, 2002, at A19.

97. Thomason, *supra* note 77.

98. Pildes, *supra* note 3, at 488.

99. See 2005 FIN. ACCT. FOUND. ANN. REP. 3 (2004) (describing the FAF's response to legislative interference regarding stock option expensing standards).

100. See Pildes, *supra* note 3, at 494–495 (describing the history of accounting regulation since the 1960s); Walker, *supra* note 5, at 6 (recounting the passage of SOX).

standards,¹⁰¹ it can undergo its own rulemaking process in order to establish accounting standards. Even easier, all the SEC has to do in order to block FASB promulgations is not recognize a specific FASB standard as authoritative.¹⁰² But the SEC's intervention into FASB work has been rare.¹⁰³ The isolated incident was a result of proposed changes to stock option expensing, the same issue that caused Congress' rare intervention into accounting rules. While the FAF was successful in deflecting Congress's intervention in 2004, the SEC did in fact interfere by changing the date of compliance originally proscribed by FASB.¹⁰⁴ Other than this occurrence, intervention by the SEC into the work of FASB is not readily found.

C. Judicial Decisions

Another option for FASB challengers is to show in court that a particular accounting treatment that they have elected is either a valid selection or that a particular accounting standard does not apply to them. This usually appears in the context of securities violation cases brought by the SEC.¹⁰⁵ Increasingly, courts have relied on nonlegal materials—such as accounting standards—in judicial decisions.¹⁰⁶ Similar to agency regulations, courts have shown a strong deference to GAAP produced by FASB.¹⁰⁷ An example is the Supreme Court's reference of several sources to understand accounting treatment and siding with materials published by FASB.¹⁰⁸ Additionally, high burdens

101. *See supra* note 55.

102. Matthew J. Barrett, *The SEC and Accounting, in Part Through the Eyes of Pacioli*, 80 NOTRE DAME L. REV. 837, 868 (2005).

103. *Id.*

104. *See* Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, 70 Fed. Reg. 20,717 (Apr. 21, 1990).

105. Thomas C. Pearson, *Creating Accountability: Increased Legal Status of Accounting and Auditing Authorities in the Global Capital Markets (U.S. and E.U.)*, 31 N.C. J. INT'L L. & COM. REG. 65, 89 (2005) (describing the frequency of securities violations cases).

106. *See* John J. Hasko, *Persuasion in the Court: Nonlegal Materials in U.S. Supreme Court Opinions*, 94 LAW LIBR. J. 427, 431 tbl.1 (2002).

107. *See* Pearson, *supra* note 105, at 98 (noting that courts have shown strong deference to particular FASB statements).

108. *See* United States v. Winstar Corp., 518 U.S. 839 (1996) (referring to accounting textbooks and treatises as well as FASB pronouncements).

of proof exist when it comes to challenging auditor opinions seemingly in line with GAAP. A plaintiff under Section 10(b)(5) of the 1934 Securities Exchange Act must show that the auditing process used to produce the opinion was so deficient as to amount to no audit at all.¹⁰⁹ Related, a plaintiff may deflect charges by showing that the accounting judgments made were not reasonable.¹¹⁰ The Private Securities Litigation Reform Act of 1995 raised this burden of proof and effectively requires that plaintiffs reference appropriate GAAP authorities.¹¹¹

Under most scenarios, it is not likely that a FASB challenger will be able to prevail against an accounting standard unless he can show a deficiency on the part of the specific accountant performing the work. It should also be noted that these cases involve defenses against criminal charges brought by the SEC.

D. Agency Challenge

Due to the difficulties outlined above, the work of FASB has been mostly insulated from challenges. This is in contrast to several other standard setters, like the EPA, the FTC, and the FCC who constantly undergo court challenges by those who are burdened by their respective regulations.¹¹² The difference is that administrative law tools clearly apply to these federal agencies¹¹³ while administrative law application is currently ambiguous when it comes to FASB.

One example of this litigation process is *Flight Int'l Group, Inc. v. Fed. Reserve Bank of Chicago*,¹¹⁴ in which the court determined that the Federal Reserve Bank of Chicago (the Fed.) was subject to the APA.¹¹⁵ In *Flight International*, an air-transport-services company challenged contracts

109. Pearson, *supra* note 105, at 89.

110. *Id.* at 90.

111. 15 U.S.C. § 78u-4(b)(1)–(2) (2006).

112. See Pearson, *supra* note 105, at 76 (describing litigation that was required to establish that many regulatory agencies are considered agencies for purposes of APA).

113. *Id.*; see Richard E. Levy & Robert L. Glicksman, *Agency-Specific Precedents*, 89 TEX. L. REV. 499, 515–551 (2011) (analyzing agency-specific administrative law precedents with case studies focusing on, among others, the EPA and FCC).

114. 583 F. Supp. 674 (N.D. Ga. 1984).

115. *Id.* at 678.

awarded by the Fed. for overnight transportation of bank checks as part of the nationwide check clearing function of the Fed.¹¹⁶ The court stated that it first needed to decide whether the Fed. qualified as an “agency” under the APA before it could review its actions.¹¹⁷ In looking to the definition of agency under the APA,¹¹⁸ the court determined that because the Fed performs “important governmental functions”—such as serving as the fiscal arm of the government—and has powers “entrusted to it” by the government, there could be “no doubt that [the Fed.] is an ‘authority’ of the government.”¹¹⁹ Additionally, the court noted that the Fed. did not fall under the exclusions listed within the APA.¹²⁰

A similar analysis could also apply to FASB, but the issue is not certain. The initial hurdle is the widely accepted perception of FASB as a private entity.¹²¹ Additionally, because of FASB’s structure, it could qualify as an agency “composed of representatives of the parties or of representatives of organizations of the parties” and be excluded under the APA.¹²² However, in the continuing discussion, I will point out why administrative law doctrines should apply to FASB.

IV. DETERMINING THAT FASB IS AN AGENCY

There are at least four reasons to believe that FASB is an agency for purposes of administrative law doctrines. First, the self-imposed agency-like operations and benefits that flow from them effectively estopp FASB from claiming it is not subject to all administrative law requirements. FASB should not be allowed to cherry pick aspects of administrative law to its benefit without also being accountable to the democratic ideals embodied in agency requirements. Second, treatment by each branch of

116. *Id.* at 676.

117. *Id.* at 677.

118. See 5 U.S.C. § 551(1) (2006) (“[A]gency’ means each authority of the Government of the United States, whether or not it is within or subject to review by another agency . . .”).

119. *Flight International*, 583 F. Supp. at 678.

120. *Id.*

121. See *supra* notes 42–49 and accompanying text.

122. 5 U.S.C. § 551(1)(E).

government is consistent with agency treatment. If all branches of the federal government recognize FASB to operate as an agency, FASB may fit into the broad agency definition under the APA. Third, the subdelegation setup between the SEC and FASB demands that FASB be subject to the same requirements that would constrain the SEC if it chose to promulgate accounting standards itself. The SEC may not get around the requirements of administrative law by simply delegating authority. Finally, the passage of SOX has solidified FASB's role as an agency. Whereas before there was no official charge given to FASB, it is now fully recognized by law as an agency and should thus also fall under the requirements of administrative law.

A. How FASB Operates

One reason is that FASB has for so long operated as a federal agency that it should fall under administrative law doctrines naturally in order to enforce proper oversight of the organization as it enjoys the benefits of acting like an agency. Ever since its founding, FASB has taken on characteristics of an agency.¹²³ In response to criticism that FASB favored regulated parties, FASB implemented formal separation from the accounting profession.¹²⁴ Part of this included creating a board that had members who were non-CPAs yet still familiar with accounting standards.¹²⁵ This allowed FASB to change its voting requirement from a five to two super majority to a simple majority.¹²⁶ FASB's response also resulted in a change to open proceedings, with dissents and other records being made public.¹²⁷ FASB also began publishing its reports periodically.¹²⁸

Additionally, FASB created the Conceptual Framework as a way of declaring its guiding principles. The Conceptual Framework contains a series of statements that provide a unified theoretical basis from which to articulate

123. See Cunningham, *supra* note 4, at 60.

124. See Van Riper, *supra* note 58, at 14 (detailing the early challenges to FASB's creation).

125. *Id.* at 86–87.

126. *Id.* at 87.

127. *Id.* at 86.

128. *Id.* at 46–47.

standards.¹²⁹ Because neither the statute delegating authority to the SEC nor any SEC materials provided these guiding principles, FASB, on its own, created the Conceptual Framework¹³⁰ as to mirror the intelligible principle required by the nondelegation doctrine.¹³¹ Related to this, FASB declared its mission to be external transparency for financial statement users which was a break from past APB goals more tilted towards the accounting industry.¹³² In doing so, FASB aligned its mission with the SEC in protecting investors and users of financial statements.¹³³ Today, FASB's understood aim is to provide relevant information to the public through public accounting.¹³⁴

Probably the most agency-mirrored improvement for FASB was the creation of its Rules of Procedure.¹³⁵ These rules are referred to as FASB's due process in accounting standard promulgation.¹³⁶ Included in these rules are requirements for notice and comment in accounting standard promulgation and an open meetings requirement.¹³⁷ FASB has itself claimed that these rules were "modeled on the Federal Administrative Procedure Act."¹³⁸ In fact, FASB further states that these rules are

129. *Concepts Statements*, FIN. ACCT. STANDARDS BOARD, <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156317989> (last visited Feb. 13, 2011).

130. See Barney, *supra* note 51 at 587–88 (noting the SEC's long history of assuming authority not technically granted by statute); Bratton, *supra* note 33, at 9 (discussing the early history of FASB).

131. See *infra* Part V.C. (discussing the requirements of the nondelegation doctrine and their relevance to FASB).

132. See Van Riper, *supra* note 58, at 20 (describing the controversy surrounding FASB's switch to decision usefulness as its guiding principle).

133. See *supra* Part IV.A.iii.

134. See Fin. Accounting Standards Bd., SFAC No. 1, *available at* <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820899258&blobheader=application%2Fpdf>.

135. Fin. Accounting Standards Bd., FASB Due Process Steps Required by the Rules of Procedure, *available at* <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175822153159&blobheader=application%2Fpdf>.

136. *Id.*

137. *Id.*

138. *Current Issues Before the Financial Accounting Standards Board: Hearing Before the Subcomm. on Commerce, Trade, and Consumer Prot.*, 107th Cong. (2001) (statement of Edmund J. Jenkins, Chairman, Financial Accounting Standards Board), *available at* <http://republicans.energycommerce.house.gov/107/hearings/07312001Hearing344/Jenkins565.htm> (last visited Feb. 13, 2011).

“broader and more open.”¹³⁹ Commentators have agreed that “changes in FASB’s procedures have further enshrined many of the norms and practices of administrative law.”¹⁴⁰

Though it may seem logical for an entity creating important national standards to follow such practices, FASB is not required to do so by either Congress or the SEC. So why adopt strict rules? Many would agree that in doing so, FASB has essentially gained widespread credibility as a standard setter.¹⁴¹ FASB’s focus on independence, financial statement user protection, and strict procedural standards has contributed to the success it has experienced with all branches of government.¹⁴² As a result, FASB has repeatedly avowed to stick to the agency model.¹⁴³ Rather than be seen as a body captured by the industry,¹⁴⁴ or as accounting experts operating in secrecy, the self-imposed limitations have created a level of comfort with the government and the public that allows FASB to enjoy its high level of regard. Especially when many of the decisions made by FASB are controversial for business managers, the ability to secure such good will with government enforcers has kept FASB in business with minimal intervention. Due to the lack of meaningful oversight by the federal government, FASB has essentially been allowed to thus far cherry pick from agency requirements in its operations; FASB has enjoyed the respect and deference due to an expert agency, but to date it has not been subject to the oversight requirements that attempt to ensure accountability for agency decision making.

139. *Id.*

140. See, e.g., Walter Mattli & Tim Buthe, *Global Private Governance: Lessons from a National Model of Setting Standards in Accounting*, 68 L. & CONTEMP. PROBS. 225, 239 (2005).

141. See Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for “Dirty Pooling” and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141, 152 (1997) (recognizing FASB as the “standard-setting body of the accounting profession”).

142. See Walker, *supra* note 5, at 1000–02 (describing how FASB has received little interference from government actors because of its neutral standard setting process).

143. Cunningham, *supra* note 4, at 62.

144. See generally Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15 (2010) (analyzing theories of agency capture).

B. Treatment by All Branches of the Federal Government Is Consistent with Agency Status

When deciding whether a governmental entity is an agency for APA purposes, courts will refer to the definition of agency provided by the Act.¹⁴⁵ This definition provides that an agency is “each authority of the Government of the United States, whether or not it is within or subject to review by another agency.”¹⁴⁶ This broad definition gives us a baseline to begin analogizing FASB to recognized agencies in order to determine whether it is an “authority of the Government of the United States.”¹⁴⁷ We can do so by cataloguing how each branch of government treats FASB and the potential reasons for this.

1. Congressional Treatment

As noted above, Congress has delegated power to the SEC to create accounting standards but also has explicitly authorized the subdelegation of this power.¹⁴⁸ The reasons for this delegation are consistent with reasons for any other agency. Accounting standards are highly technical and complex;¹⁴⁹ rather than leave the work of standard setting to legislators with busy agendas, entrusting the expertise of the accounting profession leads to efficiency from specialization.¹⁵⁰ Congress is also able to conserve its own resources.¹⁵¹ Not only does Congressional staff not have to

145. See, e.g., *New York v. Atl. States Marine Fisheries Comm'n*, 609 F.3d 524, 527 (2d Cir. 2010) (referring to the definition of agency contained in the APA to determine whether the ASMFCA was a federal agency within the meaning of the APA).

146. 5 U.S.C. § 551(1) (2006).

147. *Id.*

148. See *supra* notes 90–92 and accompanying text.

149. Cunningham, *supra* note 4, at 54.

150. See *id.* (describing efficiencies from delegation of accounting standard promulgation). That accounting standards are highly complex potentially supports the opposite determination; proponents of FASB independence argue that oversight by other entities would be fruitless. However, expertise on its own does not guarantee good decision making and standards by FASB have a real impact on the public. See Rebecca M. Bratspies, *Regulatory Trust*, 51 ARIZ. L. REV. 575, 610 (2009) (arguing that while agency work involves highly technical subject matter, agency work is “deeply embedded in a normative context” and that decisions are often between alternative social paths which are not wholly technical).

151. This is also largely dependent on how Congress chooses to set up oversight of the agency. Congress could potentially set up “police patrol” mechanisms where centralized, recurring investigation takes place. Alternatively, Congress could set

wade into the highly technical world of accounting standards, the passage of SOX ensures that funding of FASB does not come from the Congressional budget.¹⁵² Finally, by passing off the power to create accounting standards, Congress is deflecting blame for inevitable accounting scandals.¹⁵³ As evidence by its history, Congress would much rather swoop into the accounting world only when absolutely necessary.¹⁵⁴ No matter what regulations are set in place, it is inevitable that some managers will attempt to get around these rules for their personal benefit. Congress is able to play the role of savior by actively delegating responsibility for this field. Additionally, because accounting rules are usually controversial,¹⁵⁵ Congress is able to avoid upsetting constituency groups by recognizing another entity's authority to promulgate contentious standards.

Such reasons are consistent with delegation of powers to independent regulatory agencies. Technical matters such as environmental standards, food and drug standards, radio and television licensing, securities regulations, etc. have all been recognized by Congress as areas of regulation better left to those with more expertise. In many ways, this is the bedrock reason for having agencies in the first place. Additionally, though most regulatory agencies have budgets that are set by Congress and funded by taxpayers, Congress is still able to conserve its own resources by delegating responsibility. Finally, in many of these areas, Congress also has an interest in deflecting fallout from controversial decision making. In sum, the setup of delegation to FASB has been a purposeful choice by Congress if not since its inception then at least since the passage of SOX. In light of this treatment by Congress, it is difficult to argue that FASB is not intended to be an authority of the Government of the United States.

up a "fire alarm" system where investigation is only warranted when some event triggers reactionary behavior. For a discussion of the police patrol-fire alarm dichotomy in the context of international treaties, see Kal Rastiala, *Police Patrols & Fire Alarms in the NAAEC*, 26 LOY. L.A. INT'L & COMP. L. REV. 389 (2004).

152. See 15 U.S.C.A. § 7219(c)(1) (West 2011).

153. See Cunningham, *supra* note 4, at 54 n.209 (explaining the blame-deflection rationale behind delegating accounting standard promulgation).

154. See *supra* notes 103–104 and accompanying text.

155. See *supra* notes 33–44 and accompanying text.

2. Treatment by Courts

As noted above, courts have shown strong deference to accounting standards promulgated by FASB.¹⁵⁶ This level of deference is similar to *Chevron* deference granted to agencies. Under *Chevron* deference, agency interpretation of its own power in promulgating rules is given wide latitude unless the interpretation is unreasonable or clearly goes against the organic statute.¹⁵⁷

There could be several reasons for this level of deference. First, a straightforward explanation is that professional standards are usually considered when determining the appropriate standard of care.¹⁵⁸ Often an accountant will testify as an expert witness to explain GAAP requirements and the accountant's testimony is subject to the same *Daubert* analysis required of expert witnesses.¹⁵⁹ Once accepted, the expert's testimony is considered authoritative. However, this probably cannot explain the court's deference completely, especially in light of the fact that there are often dueling experts at trial.¹⁶⁰ What is more likely is that this level of deference arises because of the court's confidence that FASB standards are derived from an authoritative body that follows a process that resembles the APA's requirements of notice and comment.¹⁶¹ Because FASB has modeled its operations after that of an authoritative federal agency, courts have felt much more comfortable deferring to the expertise of FASB. The result is that courts at least treat FASB as an authority of the United States Government if not outright calling it one.

156. See *supra* Part III.C.

157. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984) (“[A] court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency”).

158. See *United States v. Simon*, 425 F.2d 796, 805–07 (2d Cir. 1969) (using compliance with GAAP as a measurable level of professional care due).

159. See Sofia Adroque & Alan Ratliff, *Kicking the Tires After Kumho: The Bottom Line on Admitting Financial Expert Testimony*, 37 HOUS. L. REV. 431, 451–52 (2000).

160. See *Rumsfeld v. United Tech. Corp.*, 315 F.3d 1361, 1367 (Fed. Cir. 2003) (explaining the potential controversy of having dueling financial experts testify to a lay jury).

161. See Memorandum of Understanding, FASB and IASB (describing FASB's rulemaking process), available at <http://www.fasb.org/news/memorandum.pdf>.

3. Treatment by the SEC

Because the SEC has explicit authorization from Congress, the SEC has the power to intervene into the processes of FASB. However, it rarely does so.¹⁶² The reason for this is likely threefold. First, as it is currently set up, the SEC appears to grant prospective rulemaking power to FASB as opposed to taking action on each standard created.¹⁶³ The implications of this setup are significant for a variety of reasons¹⁶⁴ but especially in this discussion because it has created an institutional impediment to undermining FASB's work. Rather than have the ability to review each standard, the SEC has set up a process whereby the agency must be active in overturning or revising accounting standards created by FASB. In light of this impediment, the SEC has rarely ever taken action to impede standards produced by FASB.¹⁶⁵ Second, just as with Congress, the SEC has an interest in keeping the accounting standard process independent. Third, FASB has successfully deflected interference by emphasizing neutral rules and aligning its mission with the SEC's mission.¹⁶⁶ This situation has produced the highly deferential attitude the SEC has taken with FASB.

The combination of treatment by all three branches of government is significant. Each branch treats FASB as an authority both as a result of the benefit the respective branches receive by doing so but also because of the unique nature of FASB. This treatment should not be ignored. The broad definition of agency under the APA is likely satisfied making FASB subject to administrative law doctrine.

162. See *supra* Part III.B.

163. See Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150 (Dec. 20, 1973); Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Release Act No. 33-8221, Exchange Act Release No. 3447743, Investment Company Act Release No. 26028, 68 Fed. Reg. 23,333, 23,333 (May 1, 2003).

164. See *infra* Part IV.C.

165. Barrett, *supra* note 102, at 868.

166. See Walker, *supra* note 5, at 977 (noting that FASB's neutral rule emphasis has helped keep FASB from interference by the SEC despite business people lobbying the agency).

C. Subdelegation

Congress has explicitly granted authority to the SEC to promulgate accounting standards.¹⁶⁷ Were the SEC to promulgate accounting standards themselves, these regulations would likely be subject to the APA and other constraints of administrative law.¹⁶⁸ It should follow that FASB would be subject to these same constraints, lest any agency be able to circumvent requirements by simply delegating its authority.

It is clear that agencies may subdelegate their authority to “a subordinate federal officer or agency” unless the organic statute requires otherwise.¹⁶⁹ However, delegating authority to a private entity smacks of constitutional problems.¹⁷⁰ In *U.S. Telecom Association v. FCC*,¹⁷¹ the D.C. Circuit examined whether the FCC could delegate decision making authority under a particular statute to state regulatory commissions and found that this subdelegation was unlawful.¹⁷² The court held that a “general delegation of decision-making authority to a federal administrative agency does *not* . . . include the power to subdelegate that authority beyond federal subordinates.”¹⁷³ The court was particularly concerned with administrative agencies maintaining the semblance of democracy in the actions taken.¹⁷⁴ Not allowing subdelegation from a federal agency to a state commission seems like a particularly high bar for the limits of subdelegation in comparison to subdelegation to a private entity.

Even if Congress has expressly allowed subdelegation to a

167. See *supra* notes 90–92 and accompanying text.

168. Note that SOX does not explicitly exempt the SEC from any administrative law requirements.

169. *U.S. Telecom Ass’n v. FCC*, 359 F.3d 554, 565 (D.C. Cir. 2004).

170. See Jim Rossi, *Antitrust Process and Vertical Deference: Judicial Review of State Regulatory Inaction*, 93 IOWA L. REV. 185, 223 (2007) (“Administrative law has long recognized . . . that delegations of authority to private entities also present a unique set of problems—bordering, at some level, on the unconstitutional.”). Particularly, some private delegations might run afoul of the nondelegation doctrine, especially if they enable self-dealing, as in *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935) and *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936).

171. 359 F.3d 554 (D.C. Cir. 2004).

172. *Id.* at 564–68.

173. *Id.* at 566.

174. *Id.*

private entity, this does not mean FASB should be exempt from requirements of federal agencies. In *Lebron v. National R.R. Passenger Corp.*,¹⁷⁵ the Supreme Court was asked to determine whether action by a private entity created by Congress, Amtrak, could be considered action by the government even though Amtrak explicitly denied being a federal agency.¹⁷⁶ The court found that even though Amtrak was a private corporation, its close ties to the Federal Government meant that it “must be regarded as a Government entity” for constitutional purposes.¹⁷⁷ This decision is significant because it offers validation for the idea that even though a label has been placed on an entity by statute and its own volition, the entity’s status in relation to the government should be determined functionally.

In the case of FASB, it is clear that a delegation of power has occurred. First, Congress has explicitly granted this power in statute. Prior to the Securities Exchange Act of 1933, the accounting profession policed itself.¹⁷⁸ Congress created this federal authority to oversee accounting standard setting as a result of financial turmoil.¹⁷⁹ By getting involved in the standard-setting process, Congress has effectively taken the private element out of the process and made it official. Second, recognition of accounting standards by the SEC results in legal enforcement by the federal government for violations. Financial statements that do not adhere to GAAP make public companies and their officers subject to federal charges of securities fraud. Though federal enforcement of professional standards is not always dispositive of agency status,¹⁸⁰ that the entire work of FASB is enforced by the federal government should be cause for concern in making sure that the process creating these standards is subject to some federal control. Finally, the set up between the SEC and FASB is not simply recognition of

175. 513 U.S. 374 (1995).

176. *Id.* at 377–78.

177. *Id.* at 383–92.

178. *See* Cunningham, *supra* note 4, at 41.

179. *See supra* Part III.A.

180. *See* *Noblecraft Industries, Inc. v. Sec. of Labor*, 614 F.2d 199 (9th Cir. 1980) (holding that OSHA’s enforcement of safety standards promulgated by the American National Standards Institute was valid because such standards represented a “national consensus standard”).

accounting standards as they are created; the SEC grants authoritative status to standards created by FASB *prospectively*.¹⁸¹ This type of authority presents a particular problem because it shows that any purported oversight by the SEC occurs only after enforcement. This creates a vast amount of power for FASB with only its internal procedures operating as checks. This free reign of prospective decision making is identical to what was found as unlawful in *U.S. Telecom*. Just as found in that case, the SEC should not be able to circumvent the requirements of rulemaking procedures by outsourcing its authority.

D. SOX Significance

Finally, beyond all of the structural features of FASB, the passage of SOX is the final straw needed to argue that FASB should be subject to agency requirements. As noted above, the passage of SOX marked the first time that Congress had explicitly recognized the SEC's ability to subdelegate the power to promulgate accounting standards.¹⁸² SOX provides a detailed list of what constitutes a valid entity that the SEC may subdelegate their authority to and provides a funding mechanism for the operations of the entity.¹⁸³ Though FASB is not called out by name in SOX, to date it is the only organization that fulfills the SOX requirements. This arrangement is significant for at least two reasons. First, FASB *must* adhere to these requirements in order to preserve its standard-setter status, and second, the SEC's authority has been limited by the criteria listed. Both facts combine to show that Congress has irrevocably created a governmental entity that goes beyond merely protecting an interest. With the passage of SOX, FASB has been officially authorized to act as a federal agency.

The requirements of SOX mean that in order to validly promulgate accounting standards, FASB must adhere to the statute. Before SOX, FASB was able to change itself and indeed had undergone several changes in structure and

181. Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, 68 Fed. Reg. 23,333, 23,333 (May 1, 2003).

182. See *supra* note 90 and accompanying text.

183. See *supra* note 92–93 and accompanying text.

operations.¹⁸⁴ As a private entity, FASB should be free to change its structure as deemed fit by the FAF and its constituency groups. However, any deviation from the requirements of SOX would mean FASB would likely lose its status as a standard-setting body. The effect of this is FASB can now be analogized to an agency created by Congress. Whereas before SOX there was room to argue FASB was purely a private body that the SEC would rely on to develop accounting standards that agreed with a national consensus,¹⁸⁵ now an analogy can be drawn to any federal agency where Congress specifies the structure of the organization. This increase in control by Congress further stretches the notion that FASB is anything but a government-created entity for rulemaking purposes.

Add to this structural impediment the fact that Congress has now empowered FASB to collect a tax from its constituency. Prior to SOX, FASB was funded by private donations from accounting firms and revenues from its publications.¹⁸⁶ FASB's dependence on the companies it was supposed to regulate made observers insistent on the creation of a separate funding mechanism in the interests of promoting FASB's independence.¹⁸⁷ Additionally, the funding model was unsustainable; FASB was operating at a substantial deficit in the early 2000s.¹⁸⁸ SOX mandated that

184. See *supra* Part IV.C.

185. This situation would be similar to that found in *Noblecraft* where the Ninth Circuit found that OSHA's use of safety standards promulgated by the American National Standards Institute was valid because such standards represented a "national consensus standard." 614 F.2d at 199–203. However, it should be noted that this argument is still a stretch because FASB did far more than assess national consensus in developing accounting standards. This is evidenced by the development of the Conceptual Framework as a guiding principle behind accounting standard promulgation.

186. *Subcomm. on Commerce, Trade, and Consumer Protection of the Comm. on Energy and Commerce*, 107th Cong. 2d (Feb. 14, 2002) (testimony of Edmund L. Jenkins, Chairman, FASB), available at <http://www.fasb.org/testimony/remarks.pdf>.

187. See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-02-601T, PROTECTING THE PUBLIC'S INTEREST: CONSIDERATIONS FOR ADDRESSING SELECTED REGULATORY OVERSIGHT, AUDITING, CORPORATE GOVERNANCE, AND FINANCIAL REPORTING ISSUES, STATEMENT OF DAVID WALKER, COMPTROLLER GENERAL OF THE UNITED STATES (2002).

188. See J. Richard Williams, *Funding FASB: Public Money, Public Domain*, THE CPA JOURNAL ONLINE (May 2004), <http://www.nyssepa.org/cpajournal/2004/504/perspectives/nv2.htm> (indicating an operating deficit of \$4.3 million in 2002 and \$1.1 million in 2001).

FASB raise money the same way directed for the PCAOB.¹⁸⁹ It authorizes FASB to develop “a reasonable annual accounting support fee” to be collected from public accounting firms.¹⁹⁰ Obviously, a private entity would lack any authority to set up any kind of mandatory contribution system, but what is more, FASB’s budget is now subject to approval by the SEC.¹⁹¹ These new limits on FASB’s operations should provide further evidence that Congress has legalized accounting standards and has essentially locked FASB into an agency model.

Further evidence of SOX’s impact is what it has done to limit the authority of the SEC. The flipside of the limits on FASB’s ability to change its structure is that the SEC is now limited in its ability to recognize a standard-setting body. Prior to SOX, the SEC was able to recognize, and had recognized, other entities as authoritative in promulgating accounting standards.¹⁹² The SEC continues to claim it has the power to recognize standard-setting entities outside of the criteria listed in SOX,¹⁹³ but this is not likely given a literal reading of the statute. What this means is that the SEC’s plenary power to promulgate accounting standards granted in the Securities Act of 1933 has now been curtailed. Congress has specifically chosen FASB as the standard-setting body and has limited the SEC’s ability to change this. The practical effect is that it will be nearly impossible for the SEC to recognize any other entity to promulgate accounting standards. Short of the SEC rescinding its recognition of FASB and promulgating rules itself, FASB is, for all purposes, the congressionally chosen entity to regulate accounting standards.

The analogy between Congress creating an agency through legislation and what was done to make FASB official in SOX is striking. From direction of the structure and funding as well as the apparent intent to make the

189. 15 U.S.C. § 77s(b) (2006).

190. *Id.* at § 7219.

191. See Alan Rappeport & Marie Leone, *SEC Used Budget to Strong-Arm FASB*, CFO, April 3, 2007, <http://www.cfo.com/article.cfm/8959118> (stating that “since Sarbanes-Oxley, it is the SEC’s Office of the Chief Accountant that approves the FASB budget”).

192. See *supra* Part II.A.

193. Cunningham, *supra* note 4, at 33.

SEC–FASB relationship permanent, it is as if Congress has created a new iteration of FASB. Congress’s intent to make FASB the regulator of accounting standards is clear in SOX. As a result, FASB should be subject to the same requirements of any regulatory entity created by Congress.

V. IMPLICATIONS OF FASB’S AGENCY STATUS

If FASB indeed has agency status, it would become subject to administrative law doctrines. As a result, any deficiencies in light of these requirements might result in nullifying many if not all accounting standards. There are at least three potential bases for challenging FASB standards. First, a challenge could be based on the requirements of the APA. Such applicable requirements include notice and comment opportunity, public meetings and public disclosure of FASB documents, and subject to judicial review. Given the self-imposed procedures, though, these challenges are likely moot. Second, just as in *Free Enterprise Fund*, the appointment and removal process for FASB members could be challenged as unconstitutional. The President and SEC have even less authority over FASB membership, and based on the Supreme Court’s determination in *Free Enterprise Fund*, the FASB’s appointment and removal process is likely unconstitutional. However, the available remedy is uncertain given how limited the remedy was against the PCAOB. Finally, nondelegation principles provide a potential challenge. Though the nondelegation doctrine has been a relatively weak oversight tool, an intelligible principle from Congress that directs agency work is a requirement that may present a successful challenge basis. Though FASB has provided its own governing principles, it is unclear whether Congress has provided the required intelligible principle to FASB.

A. Statutory Requirements

Statutory checks on agency power include judicial review; notice and comment provisions in the APA;¹⁹⁴ access to records mandated by the Freedom of Information Act

194. 5 U.S.C. §§ 551–559, 701–706 (2006).

(FOIA);¹⁹⁵ and the open-meeting requirements of the Government in the Sunshine Act.¹⁹⁶ The APA requires that for rulemaking to be valid the agency must (1) publish general notice of the proposed rule in the Federal Register¹⁹⁷ and (2) give interested persons “an opportunity to participate in the rule making through submission of written data, views, or arguments.”¹⁹⁸ It also requires that final rules be published in the Federal Register at least thirty days before becoming effective.¹⁹⁹ FOIA requires disclosure of federal agency records upon request by “any person,”²⁰⁰ subject to nine enumerated exemptions.²⁰¹ The Government in the Sunshine Act requires open meetings for agencies headed by multimember boards.²⁰²

Given the requirements of the Rules of Procedure instituted by FASB itself,²⁰³ it is not clear how successful a statutory-based challenge would be. To some extent, FASB already provides for many of these statutory requirements. FASB provides for notice and comment in most projects.²⁰⁴ This includes releasing an exposure draft of the proposed accounting standard and receiving public comment letters.²⁰⁵ Deliberations by FASB are held as public roundtables in two stages: one after initial release of an exposure draft and a second after public comment letters are collected.²⁰⁶ FASB defines its public record as “[l]etters of comment and position papers, research reports, and other relevant materials on projects leading to issuance of pronouncements.”²⁰⁷ This public record is available for

195. *Id.* § 552.

196. *Id.* § 552b.

197. *Id.* § 553(b).

198. *Id.* § 553(c).

199. *Id.* § 553(d).

200. *Id.* § 552a.

201. *Id.* § 552b(e)(1)–(9).

202. *Id.* § 552b.

203. *See supra* notes 177–182 and accompanying text.

204. *Facts About FASB, Our Standard Setting Process*, FIN. ACCOUNTING STANDARDS BD., <http://www.fasb.org/facts/index.shtml#decision-making> (last visited Mar. 4, 2011).

205. *Id.*

206. *Id.*

207. *Facts About FASB, Our Standard Setting Process*, FIN. ACCOUNTING STANDARDS BD., http://www.fasb.org/facts/facts_about_fasb.pdf (last visited Mar. 4, 2011).

inspection in a public reading room at FASB offices as well as online in some instances.²⁰⁸

One potential deficiency is the absence of available judicial review. However, it's not likely that this would be enough to invalidate FASB pronouncements. Though there is no avenue for a direct challenge to accounting standard promulgation, those affected by accounting standards, such as defendants in financial fraud cases, are currently allowed to challenge the application of the accounting standard to their particular circumstances.²⁰⁹ Judicial review is available to ensure compliance with federal statutes, but federal courts will often defer to agency interpretations under the *Chevron* and *Skidmore* doctrines.²¹⁰ This level of deference has in fact played out as courts consider the validity of GAAP in specific cases.²¹¹ These facts coupled together make a judicial review challenge weak.

B. Appointment/Removal Challenge

Aside from statutory challenges, potential challengers could take a cue from *Free Enterprise Fund* and challenge the appointment and removal of FASB members.²¹² FASB members are selected by its governing organization, the FAF.²¹³ Removal of FASB members is only permitted by a two-thirds vote of the FAF and only for cause.²¹⁴ The FAF board members are elected by the member organizations²¹⁵ and can be removed only for cause by a two-thirds vote of the FAF board.²¹⁶

Appointment and removal jurisprudence has seen several landmark cases decided by the Supreme Court in an attempt to define the appropriate power to structure federal

208. *Id.*

209. *See supra* notes 114–117 and accompanying text.

210. Evan J. Criddle, *Fiduciary Administration: Rethinking Popular Representation in Agency Rulemaking*, 88 TEX. L. REV. 441, 445 (2010).

211. *See supra* notes 114–117 and accompanying text.

212. *See supra* notes 24–29 and accompanying text.

213. Bratton, *supra* note 33, at 14.

214. Fin. Accounting Standards Bd., By-Laws of the Financial Accounting Foundation, Chapter A, Article II-A Financial Accounting Standards Board, Section 3: Appointment of Members.

215. *See supra* note 76 and accompanying text.

216. Fin. Accounting Standards Bd., By-Laws of the Financial Accounting Foundation, Section 6: Elections and Removal.

agencies.²¹⁷ The Constitution provides that the president shall appoint all principal executive officers with the advice and consent of the Senate.²¹⁸ However, Congress can vest power to appoint inferior officers in the President, courts, or heads of department.²¹⁹ In terms of removal, Congress cannot limit the President's power to remove principal officers,²²⁰ but may impose conditions on the removal of inferior officers.²²¹ The limits of Congress's power to impose conditions was at the center of the *Free Enterprise Fund* case.²²²

Often the distinction between principal and inferior officers is important because of the differences in what Congress may do.²²³ However, in the case of FASB, we do not need to go that far because it is clear from the structure that the President is not involved in the process at all. Whereas in the PCAOB arrangement, the President appoints members of the SEC who then appoint PCAOB members, that is not the case for members of the FAF. If FASB is a federal agency subject to administrative law doctrines, its current member selection and removal process is unconstitutional. However, the remedy would likely be similar to that proscribed by the Supreme Court in *Free Enterprise Fund*. Even though the removal process was found unconstitutional, rather than order an injunction of all PCAOB work until SOX could be amended (or, as the parties in the case *really* wanted, a declaration of unconstitutionality for SOX in its entirety), the Supreme Court simply held that PCAOB members could be removed at will by the SEC no matter what the prescribed method

217. See, e.g., *Edmond v. United States*, 520 U.S. 651 (1997) (holding appointment of military courts of appeals judges appointed by the Court to be constitutional); *Morrison v. Olson*, 487 U.S. 654 (1988) (holding Independent Counsel not appointed by the President with the advice and consent of the Senate to be constitutional); *Bowsher v. Synar*, 478 U.S. 714 (1986) (holding that removal of the Comptroller General by Congress to be unconstitutional); *Buckley v. Valeo*, 424 U.S. 1 (1976) (holding Federal Elections Commissioners selected by Congress to be unconstitutional); *Myers v. United States*, 272 U.S. 52 (1926) (holding removal of a postmaster by Congress to be unconstitutional).

218. U.S. CONST. art. II, § 2, cl. 2.

219. *Id.*

220. *Myers*, 272 U.S. at 117.

221. *Id.* at 161.

222. Keefe, *supra* note 23, at 1664.

223. *Myers*, 272 U.S. at 164.

said.²²⁴ Applying the same remedy to FASB would mean that board members would be removable at will by the SEC, but it would do nothing to stop the work of FASB.

C. Nondelegation Doctrine

Another available constitutional challenge is based on the nondelegation doctrine. The nondelegation doctrine requires that Congress not delegate to another branch its “essential legislative functions.”²²⁵ Though a potentially broad restriction, the Supreme Court has only found a violation of this doctrine twice, both over seventy years ago.²²⁶ In reality, Congress is permitted to delegate power under broad general directives.²²⁷ Though technically still in effect, most commentators would agree that the nondelegation doctrine does not stand as an effective tool to constrain Congress.²²⁸

However, one important aspect of the nondelegation doctrine is a requirement that Congress provide an intelligible principle when delegating authority to an agency.²²⁹ This intelligible principle is to guide agencies when exercising their delegated authority.²³⁰ It also serves the courts in judicial review as a baseline reference to whether the agency is acting within the scope of its authority. In practice, this is also not much of a restriction. Vague directives included in statutes have often been approved as adequate by the court.²³¹

In the case of FASB, it may be that an intelligible principle is missing both from SOX and from recognition by the SEC. When FASB was formed, drafting a goal-setting

224. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 130 S. Ct. 3138, 3161–64 (2010).

225. *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, 529 (1935).

226. *See* *Whitman v. Am. Trucking Ass’n*, 531 U.S. 457, 474 (2001) (stating that the two cases were *Schechter Poultry*, 295 U.S. at 495, and *Panama Refining Co. v. Ryan*, 293 U.S. 388, 430–33 (1935)).

227. *Mistretta v. United States*, 488 U.S. 361, 372 (1989).

228. *See, e.g.*, GEOFFREY R. STONE ET AL., *CONSTITUTIONAL LAW* 366 (4th ed. 2001) (arguing that “statutes authorizing regulation of ‘unreasonable risks’ or administrative action ‘in the public interest’ appear immune from attack”).

229. *Am. Trucking Ass’n*, 531 U.S. at 472.

230. *Id.*

231. *See* Randolph J. May, *The Public Interest Standard: Is It Too Indeterminate to Be Constitutional?*, 53 *FED. COMM. L.J.* 427, *passim* (2001) (discussing the history and current implications of the nondelegation doctrine).

standard was left to FASB itself.²³² This freedom was what led to the creation of the Conceptual Framework by FASB.²³³ Though FASB adopted the same mission as the SEC, this was not mandated by the FAF, the SEC, or Congress. The fact that the principle adopted by FASB was controversial further evidences that the Conceptual Framework was not mandated or necessarily expected.

The passage of SOX presents a possible counterargument. Part v. of the subdelegation requirements proscribes that the entity “considers, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors.”²³⁴ This requirement may provide a three-part principle: that created accounting standards (1) reflect business changes, (2) consider international accounting standard convergence, and (3) protect investors. Given the broad directives previously allowed, this may be enough to constitute a guiding principle to the entity recognized as the accounting standard setter.

VI. CONCLUSION

The ramifications of administrative law requirements on FASB are far reaching. As discussed at the start of this Note, the financial system of the United States is highly dependent on accounting information and, therefore, on accounting standards.²³⁵ Any disruption to these standards could have wide-ranging, and long-lasting, effects on the financial markets and economic health of the country. Though these affects are beyond the scope of this Note, it is worth noting that even though future challenges to FASB based on agency grounds are likely to be on point theoretically, as a practical matter, instituting any kind of major change into the regulatory model now in place requires careful consideration. Ultimately, the question cuts two ways: the Court must weigh the benefits of

232. Van Riper, *supra* note 58, at 74–78.

233. *See supra* Part IV.C.

234. 15 U.S.C. § 77s(b)(1)(A)(v) (2006).

235. *See supra* notes 7–9 and accompanying text.

implementing administrative law requirements versus keeping the current system for reasons of familiarity and predictability. The goal of this Note is to provide the basis for properly making that decision, whatever it might turn out to be.