

Tax Fairness And Effective Tax Rates: A Tale Of Two Industries

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Abstract

Industries with low effective tax rates could reasonably expect to suffer as a result of legislation designed to increase tax fairness. We analyzed ETRs in two such industries, banking and oil and gas, over a period of time that included two major tax law shifts. Our results suggest that legislation designed to promote tax fairness affects industries in an idiosyncratic manner.

Introduction

Given the current debate over budget deficits, flat tax proposals, and fundamental changes in the way individuals and corporations are taxed, policymakers would do well to reflect on the results of past attempts to alter the tax landscape. Tax-favored industries, that is, industries with relatively low effective tax rates (ETRs), could reasonably expect to suffer at the hands of lawmakers attempting to increase tax fairness. Some industries, however, may be politically immune, or at least resistant, to ETR-changing legislation.

We analyzed effective tax rates in two industries, banking and oil and gas, over a period of time that included two major tax law shifts, the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Reform Act of 1986 (TRA 86). Our goal was to explore how industries, which historically have had lower-than-average ETRs, are affected by legislation designed to increase tax fairness.

Consistent with the general results obtained by Manzon and Smith (1994), we found lower ETRs after ERTA and higher ETRs com-

bined with ETR convergence after TRA 86. The banking industry seems to have endured a greater ETR increase than the oil and gas industry as a result of TRA 86. Our results suggest that tax legislation driven by tax fairness may yield idiosyncratic results among industries that have received preferential treatment in the past.

Literature Review

Tax efficiency was a major theme of ERTA, and some commentators have suggested that a reduction in tax fairness was part of the cost of the tax efficiency ERTA was to have delivered (see, Witte 1985, pp. 220-243). Later, as enactment of the Tax Reform Act of 1986 approached, rhetoric emphasizing growing budget deficits and tax fairness ruled the day. We included ERTA in our analysis as a control to determine if the ETRs of the two industries under examination behaved as expected in response to tax legislation that did not emphasize tax fairness. Our expectations were confirmed as described below.

In the corporate arena, discussions about the distributional effects of changes in the tax law often have focused on comparisons of effective tax rates (e.g., Government Accounting Office 1990; Shevlin and Porter 1992; and Manzon and Smith 1994). Prior research paints a fairly consistent picture of the effects of ERTA and TRA 86 on ETRs: ERTA lowered ETRs; TRA 86 increased ETRs but reduced the variability of ETRs. This seems to be true across industries and for various size corporations (Citizens for Tax Justice 1988, 1989; Government Accounting Office 1990; Shevlin and Porter 1992; Kern and Morris 1992; and Manzon and Smith 1994).

The General Accounting Office (1990), while noting (p. 28) that "more than one year of data would be needed ... to do a comprehensive analysis of TRA's effect," examined changes in ETRs in the TRA 86 transition years 1986 and 1987. Citizens for Tax Justice (1988; 1989) examined ETR changes from 1981-1985 to 1987 and 1988 for large companies but provided no statistical analysis. Shevlin and Porter (1992), using firms analyzed in prior studies (Citizens for Tax Justice 1988; 1989), examined changes in ETRs before (1984 and 1985) and after (1988 and 1989) TRA 86. They found (p. 69), using a statistical rigor lacking in the Citizens for Tax Justice and General Accounting Office studies, that TRA 86 contained tax rule changes that increased ETRs and tax rate changes that reduced ETRs. Although they did not address changes in the level and distribution of ETRs, Kern and Morris (1992, p. 82) provided some evidence that TRA 86 mitigated large and small firm ETR differences.

In a more comprehensive analysis of changes in the level and distribution of ETRs, Manzon and Smith (1994) examined changes in ETRs during the years prior to ERTA (1978-1980), after ERTA but prior to TRA 86 (1982-1985), and following TRA 86 (1988-1990). They found that large firms that made significant capital investments benefited most from ERTA but that ERTA did not appear to exacerbate existing industry differences. Manzon and Smith (1994) found that TRA 86 increased ETRs and reduced the variation in ETRs between industries.

ERTA was to have stimulated economic activity by reallocating and lowering taxes. Included in the plan to reallocate tax burdens was a shift in the relative tax burdens of corporations and individuals. The Joint Committee on Taxation (1982) estimated that total tax revenues from corporations would fall to less than 7 percent in 1986 from about 13 percent in 1981. This shift in the tax burden away from corporations was accompanied by a major restructuring of the tax rates for individual taxpayers, but the reallocation of tax burdens was not implemented in as orderly a fashion as ERTA's engineers might have wished.

Of the political process that preceded ERTA, David Stockman, the director of the Office of Management and Budget when ERTA was passed, said, "The hogs were really feeding. The greed level, the level of opportunism, was just out of control." (Greider 1981, p. 51) As to the reallocation of tax burdens, Mr. Stockman said, "It's kind of hard to sell 'trickle down,' so the supply-side formula was the only way to get a tax policy that was really 'trickle down.' The hard part of the supply-side tax cut is dropping the top rate [for individuals] from 70% to 50% - the rest is a secondary matter. ... In order to make this palatable as a political matter, you had to bring down *all* [emphasis added] the brackets." (Greider 1981, pp. 46-7)

Although the primary thrust of ERTA was tax efficiency, using "trickle down" as the method of delivery, the political process described by Mr. Stockman was not void of fairness considerations. Fairness, however, tended to be a by-product of a political process focused on tax efficiency. Rarely were such considerations the result of philosophical consistency. Deductions for IRA contributions, for example, were made available to all taxpayers because such deductions were already so widely available that those taxpayers unable to deduct IRA contributions were thought to be placed in an unfair position. "This is a marvelous example of a common tax phenomenon: a device created to cover a tax-disadvantaged minority expands until those eligible become so numerous that the remainder

are unfairly disadvantaged." (Witte 1985, p. 223)

Although many of the provisions in ERTA resulted from the political battles of the day, the economic forces that made reducing ETRs politically appealing had been building for some time. Faltering real income and the inflation of the prior decade contributed to these pressures by fueling bracket creep (Steuerle and Hartzmark 1981). Perhaps as a result, both major political parties supported special-interest provisions in what some have called a bidding war. Ironically, efforts to add politically appealing provisions may have been, to some extent, encouraged by 1970s reforms that made the legislative process more available to the public (Witte, 240). In any event, ERTA became a juggernaut, bound for passage.

The Ways and Means bill resembled a set of blocks, haphazardly arranged, with the principal goal of offering a wide enough range of benefits to make it politically irresistibleBeyond the wide range of benefits agreed to in the first round of bargaining, the committee added a number of benefits targeted at specific industries. ...Because the House and Senate bills were so similar, the Conference Committee met for only one day. Accommodations were quickly reached What is more important is what the Conference Committee did not do. In the past the Conference Committee served as a final filter for eliminating large numbers of provisions that had been added at some point in the legislative process, but for which there was little consensus on the tax committees. This filter limited revenue losses and thus balanced the bill. In this case, however, the disjoint legislative sequence, the early agreement on a wide range of relief provisions, and the subsequent bidding war produced bills very similar in philosophy and substance and aborted the moderating influence of the Conference Committee. (Witte 1985, 227-30)

During the years following ERTA, public sentiment fueled a debate about the fairness of the federal tax system. This debate was not focused on specific industries but, rather, seems to have been the result of a vague, but widespread, belief

that something was not right, especially with respect to the relative tax burdens of large corporations. The rapid depreciation methods and safe harbor leasing provisions contained in ERTA allowed some large corporations to pay very low effective tax rates (See Citizens for Tax Justice 1984, 1985, 1986; Stickney, Weil, and Wolfson 1983; and Wheeler and Outslay 1986). When Donald Regan, Secretary of the Treasury during the Reagan Administration, told President Reagan that Reagan's secretary "paid more federal taxes than [many] giant companies put together," Reagan is said to have replied, "I just didn't realize that things had gotten that far out of line." (Regan 1988, p. 217)

Situations of this sort lead Michael Boskin, Chairman of Reagan's Council of Economic Advisors, to make the following observation concerning TRA 86:

There will be fewer complaints that the typical individual paid more in taxes than a set of corporations which managed to pay none. Beside the fact that this misses the point that personal taxes were probably paid on dividends paid by the corporation or that it may be paying no taxes because of carrying forward substantial losses, we probably could benefit from a decrease in the public stridency with which our tax system was continually denounced. (Boskin 1986, p. 11)

Boskin seems to have been saying that TRA 86 was largely about the *appearance* of tax fairness. Even the Treasury Department joined those calling for a "level playing field" (Summers 1986, 119): "[A]n overriding objective [of tax reform] is to subject real economic income from all sources to the same tax" (U.S. Treasury Department 1984).

In an attempt to level the playing field, Congress included in TRA 86 many provisions aimed at redistributing tax burdens. One purpose of the alternative minimum tax, for example, was to reduce the number of large corporations with little or no current tax due. Some provisions were aimed directly at the banking and oil and gas industries. Legislation concerning banks in TRA 86 was guided by the belief that banks enjoyed un-

fairly low tax rates (Grammatikos and Yourougou 1990). The Joint Committee on Taxation calculated that the ETR paid by large banks never exceeded 6 percent during 1980-83. Perhaps as a result of this finding, TRA 86 changed the way many banks must compute deductions for bad debts (see Grammatikos and Yourougou 1990 for a detailed analysis of the effect of TRA 86 on U.S. banks). In many cases, the cumulative effect of ERTA and TRA 86 may have been to create inequities between large and small corporations while promoting horizontal equity among large corporations. For example, ERTA exempted independent stripper production from the 1980 windfall profits tax.

Of course, ERTA and TRA 86 are not the only congressional actions to have had an affect on tax fairness. Special-interest legislation has created horizontal inequities that are deeply rooted in many industries. Elimination of the depletion allowance in 1975 for most large corporations, for example, came about only as a result of an unlikely combination of events.

All it took was the oil embargo and the quadrupling of oil prices in eighteen months, a liberal Democratic landslide following the worst political scandal in American history, the downfall of a longtime committee chairman at the height of his power, the expansion and "stacking" of the Ways and Means and Rules committees, and a unique revolt in Congress that permitted the membership to overrule party leadership on a critical issue. Tax expenditures as carefully fortified as the depletion allowance do not die easily. (Witte 1985, 185)

The above examples are not exhaustive. They only illustrate the way tax legislation affects the slope of the playing field upon which industries compete. We chose the banking and oil and gas industries as representative examples of industries with a history of preferential tax treatment. Also, both industries will almost certainly be of continuing interest. Banks have an obvious link to the United States and world economies, and the industry is constantly expanding its participation in nontraditional and potentially more risky activities (see Johnson and Murphy 1987). Oil and gas

firms play enormous environmental, economic, and national security roles.

Method

We used firms on the Compustat database to examine ETRs for three industry groups during the years prior to ERTA (1978-1980), after ERTA but prior to TRA 86 (1982-1985), and following TRA 86 (1988-1990). The three industry groups used in our analysis were made up of (1) 224 oil and gas firms, (2) 45 banks (SIC code 6020), and (3) all other firms on the Compustat database. Oil and gas firms were identified by SIC codes 1311 (producers), 1381 (drillers), 291 (integrated oil companies), and 492 (natural gas distributors). Firms that did not have adequate information to calculate our ETR measures for the three time periods were excluded from the analysis. In addition, firms with negative total reported income over the entire measurement period were excluded. ETRs were computed as follows:

$$\text{FETR} = \text{FEDTAX} / \text{PREINC} \quad (1)$$

where:

FETR = the federal effective tax rate;
 FEDTAX = the sum of current federal income tax (Compustat data item # 63) for the time period; and
 PREINC = the sum of pretax income (Compustat data item #170) for the time period.

These measures are similar to those used by Shevlin and Porter (1992). For banks, the measure used for FEDTAX was the federal current taxes payable. Data for this variable was collected from proxy statements and other filings by banks with the Securities and Exchange Commission.

Results

Table 1 shows the median ETRs for the three industry groups examined. Consistent with prior research, we found that ERTA reduced median federal ETRs for the three industry groups examined. The oil and gas industry went from a

median federal ETR of 11.1 percent during the pre-ERTA period to a median federal ETR of 9.9 percent after ERTA. The banking industry went from a median federal ETR of 7.6 percent to a median federal ETR of 5.0 percent over the same time period. The median federal ETR for the group that contained all other firms declined from 24.3 percent prior to ERTA to 20.1 percent after ERTA. The only group that had a post-ERTA median federal ETR that was statistically significantly different from its pre-ERTA median federal ETR was the group that included all firms other than banks and oil and gas firms.

After TRA 86, median federal ETRs increased for all groups examined. The oil and gas industry went from a median federal ETR of 9.9 percent before TRA 86 to a median federal ETR of 13.8 percent after TRA 86. The median federal ETR for the banking industry increased from 5.0 percent before TRA 86 to 23.3 percent after TRA 86. The median federal ETR for all other firms increased from 20.1 percent to 24.9 percent. The higher median federal ETRs found after TRA 86 were statistically significant different from those during the post-ERTA period for banks and for all other firms. An analysis using average ETRs showed similar results.

Discussion And Conclusions

The ETRs in Table 1 are presented graphically in Figure 1. As Table 1 and Figure 1 show, ERTA accomplished at least one of its goals: it lowered the ETRs of many corporations. The ETR decline, to the extent it may have affected the oil and gas and banking industries, ap-

pears to have been fairly uniform for the three groups examined. That is, all groups appear to have benefited from ERTA in roughly equal amounts even though the banking and oil and gas industries already had a substantial tax advantage over other firms. The decline in ETRs brought about by ERTA was not statistically significant, however, so ERTA may well have merely left the two tax-favored industries as it found them. The failure of ERTA to have a statistically significant effect on either of the two tax-favored industries is, perhaps, not surprising. As shown in Table 1 and Figure 1, the ETRs of both industries were already substantially below the ETRs of other corporate taxpayers.

TRA 86, which emphasized tax fairness, does not appear to have had a similar effect on the industries examined. While median federal ETRs rose for all industry groups, the banking industry appears to have taken a particularly bad beating at the hands of the field-leveling provisions of TRA 86. This was probably due in large part to changes required under the provisions of TRA 86 in the way banks compute the deduction for bad debts and the transition rules related to these changes. As was the case for ERTA, TRA 86 did not affect the oil and gas industry to a degree that was statistically significant.

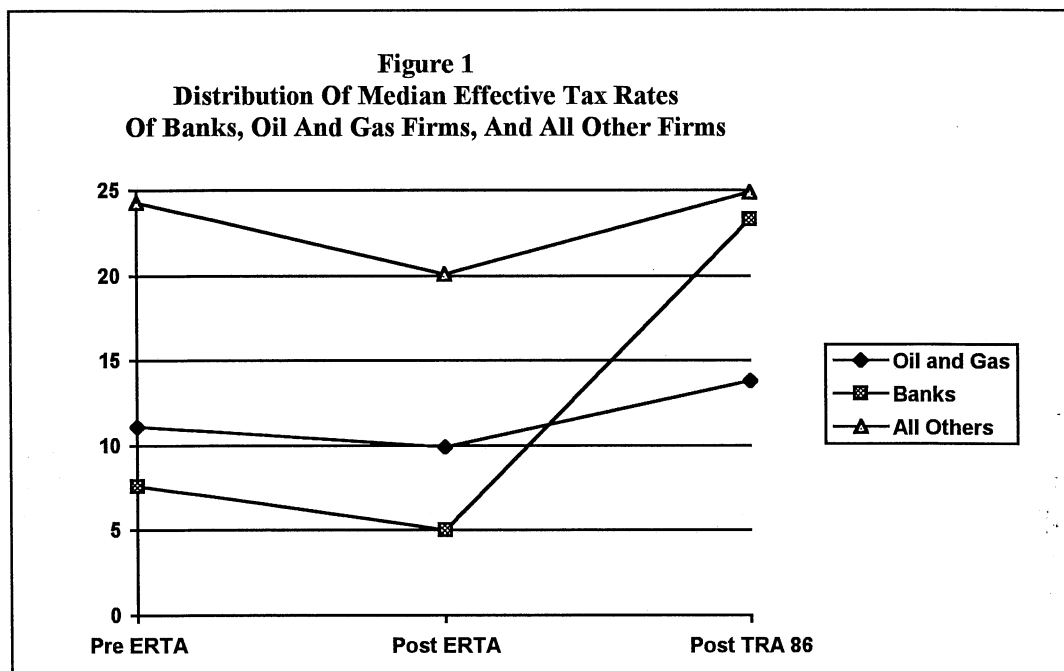
Implications For Future Research

In the end, ERTA, which was primarily concerned with increasing economic efficiency, seems to have benefited all industries. That is, ERTA's results appear to have been distributed fairly evenly. TRA 86, which was concerned primarily with creating a level playing field, seems to have produced more erratic results, perhaps especially so among industries with a history of preferential tax treatment. This apparent paradox may merit further investigation to determine fruitful directions for future tax legislation. ☐

Table 1
Distribution Of Median Effective Tax Rates
Of Banks, Oil And Gas Firms, And All Other Firms

	Pre-ERTA	Post-ERTA	Post-TRA 86
Oil and Gas	11.1	09.9	13.8
Banks	07.6	05.0	23.3*
All Others	24.3*	20.1	24.9*

*Significantly greater than post-ERTA median at .01 level (Wilcoxon rank-sum test).



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An Analysis of the FASB's Independence

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Abstract

The Financial Accounting Standards Board (FASB) has been criticized over the past twenty years for, among other things, a lack of independence. Although, in contrast to other countries, the FASB's accounting pronouncements are promulgated in an arena and spirit of due process and openness in order to achieve independence, if it is true that Board members are not, in fact, acting independently, it cannot be stated that the extant organizational structure is achieving this objective. Accordingly, this paper examined the voting behavior of FASB members in order to determine if there was a linkage between their votes and the positions of their former employers. The results indicate that the Board members act independently in casting their votes and that in this regard the organizational structure of the FASB is achieving its goal, at least in regard to the criterion of independence.

Introduction

The independence of the standard setter and the neutrality of the standards are critical to the credibility and reliability of reported information. Without independence and neutrality, financial reporting can become propaganda. *Dennis R. Beresford, Chairman, Financial Accounting Standards Board* (Beresford, 1995, p. 61).

In 1987, Arthur Wyatt resigned from the Financial Accounting Standards Board (FASB), stating in an article in the *Wall Street Journal* (Berton & Ricks, 1988) that he was frustrated over the increasing role of business in accounting standard-setting, and that business pressure was a major problem for the Board. He further elaborated that a problem existed in that the FASB is expected to be independent of companies affected by its standards, but that the Board is then strongly criticized for rules that businesses disagree with. Despite the fact that eight years have passed since Wyatt aired this frustration, this climate of criticism by business of the FASB's efforts in ac-

counting standard-setting has endured. For example, in the matter of accounting for employee stock options, the FASB was faced with intense opposition by the business community. Walter P. Schuetze, the Chief Accountant to the Securities and Exchange Commission (SEC), went so far as to label the national CPA firms "cheerleaders" for their clients in their lobbying efforts (Schuetze, 1994 p. 74). Eventually the pressure caused the Board to reverse its earlier decision to report the value of employee stock options as an expense. Chairman Beresford told the *Journal of Accountancy* (February, 1995, p.18) "No matter how hard we tried to convince people of the correctness of our stand, there simply was not enough support for the notion of requiring expense recognition."

The stock option case is evidence that massive collective lobbying can, on occasion, influence the FASB's deliberations. However, given the threat of government intervention in accounting for stock options had the Board required expense

recognition, the FASB can hardly be faulted for acquiescing to the pressure. Nonetheless, since the FASB's accounting standards are so important to U.S. businesses, and given Mr. Beresford's comments on the need for the independence of accounting standard-setters, an appropriate area of examination is the degree of independence of Board members when they vote on the financial accounting standards before them. As Chairman Beresford stated, ". . . I am convinced that only by retaining our independence and objectivity and only by continuing to be seen as setting the most neutral financial standards possible can we retain the trust of the SEC" (Beresford, 1993, p.75). Given this background, we conducted a study of the Board's independence and describe the results in this article. Our findings suggest that the individual Board members, do, in fact, manifest virtually complete independence, at least in regards to the party who would be the most likely to influence a Board member's voting behavior; his former employer.

The FASB's Strive for Independence

One frequently cited reason for the demise of the Accounting Principles Board (APB) was an alleged lack of independence. Board members were often accused of acting in accordance with the wishes of their parent organizations, most of which were audit firms. Wyatt stated that by 1972 there was a great deal of concern that the APB was being improperly influenced by certain clients and that this type of behavior was probably a prime force for the establishment of the FASB.

The FASB is different in many respects from the APB, a major one being that its members are required to sever employment ties with their firms. Despite this prerequisite, as well as other aspects of the Board's organizational structure intended to promote independence, the FASB has not been free of criticism. For example, in 1976 the late Senator Lee Metcalf (D-Montana) issued a rather vitriolic report entitled *The Accounting Establishment* (Metcalf, 1976) in which he alleged, among other things, that the then Big Eight accounting firms controlled the establishment of the accounting standards used by their corporate cli-

ents. More recently, in 1988 the Business Roundtable, a powerful business lobbying organization, pressured the SEC to investigate as to whether the FASB needed to be overhauled. Its complaint focused primarily on the perceived impracticality of the accounting standards issued by the FASB as well as the cost of implementing the standards.

The FASB operates in a forum that is quite different from many of its counterpart organizations in other countries. A primary difference is that the FASB's accounting pronouncements are promulgated in an arena and spirit of due process and openness. As an example, the general public is admitted to all of its meetings. This contrasts with the rather closed accounting standard-setting process that exists in Australia, Canada, Japan, New Zealand, Sweden, Switzerland, and West Germany. Furthermore, to our knowledge, the requirement of Board members to sever employment ties is also unique to the FASB. These dual requirements of openness and severance are, of course, intended to enhance independence. If, however, it is found that any members of the Board are not, in fact, acting independently, it cannot be stated that the extant organizational structure is achieving this objective.

There have been several studies involving the voting behavior of FASB members, most of which have primarily focused on alleged coalition voting by Board members who were formerly associated with the then Big Eight firms. In general, the results did not indicate evidence of coalition voting. We conducted an earlier study of FASB voting behavior that differed from previous research efforts in that our work tested whether there was a linkage between the votes of individual Board members and the positions of their former employers towards a proposed accounting standard (Martens and McEnroe, 1993). The study involved an analysis of the voting behavior of Board members who were previously public accountants, and encompassed FASs Nos. 26-71. We found no evidence of favoritism by these individuals towards their former firms. FAS 71, however, was issued in December, 1982, over thirteen years ago. Accordingly, we felt that it was now appropriate to conduct a similar study pertaining to subsequent


fering the argument as if it were his own. This area of analysis also included those situations in which the former employer was in favor of the overall standard but was opposed to some provision. Accordingly, 16 letters were analyzed (14 from the "in favor with modification" classification and 2 from the "opposed to standard" group) and compared with the respective Board member's reason for casting a dissent vote. We found that the objections cited in the comment letters did not correlate with the reason for the Board member's dissent. In a very few cases a sentence or two of the Board member's dissent might have overlapped in general with a point or two contained in the former employer's comment letter; however, in no case was a *verbatim* sentence or phrase taken from the comment letter and utilized by the Board member as if it were his own argument.

Conclusions

This study, consistent with our earlier research, found no evidence that FASB members vote in accordance with the positions of their former firms. Indeed, Board members voted in favor of the passage of an accounting standard at about the same percentage when their former employer was in favor of the standard as when the employer opposed the promulgation. Furthermore, a comparison of Board members' objections cited in casting a negative vote did not agree with their former employers' objections. Thus, the empirical evidence suggest the members acted independently when casting their votes, and the findings support the notion that the organizational structure of the FASB is meeting its goal, at least as far as the above criterion.

Implications For Future Research

Given our findings of independence on the part of the FASB, consistent with our previous study, future research might attempt to determine why such vehement criticism of the FASB exists. For example, is the FASB viewed by the business community as being perhaps too independent and/or inflexible. An associated question relates to whether the FASB is actually perceived to be anti-business by corporate executives as suggested re-

cently by a Wall Street Journal columnist (Lowenstein, 1996, p.C1). In any event, a fruitful area for further research is a determination of the exact reasons for the business community's displeasure with the FASB. Perhaps the findings could help both parties to reduce the tension between them and enhance the forging of financial accounting principles that will further benefit the users of the financial statements of publicly traded entities. 

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