SPECIAL REPORT

Benefits, Costs, and Consequences of Financial Accounting Standards

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Financial Accounting Standards Board
of the Financial Accounting Foundation
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FOREWORD

In debates over proposed accounting standards, the Financial Accounting Standards Board is frequently challenged to measure the expected *benefits* to the large and diverse community of users of financial information versus the *costs* of that information. In most cases, the best that can be done is conscientious judgmental assessment of costs and benefits. The FASB is committed in its statement of mission and in its conceptual framework to make such assessments on all its projects.

The task is complicated by the fact that a large portion of the costs are incurred by a community of financial statement preparers that for the most part is relatively homogeneous, well organized, and articulate, but the benefits accrue to a very large, heterogeneous, and unorganized universe of users of financial information. In fact, one can argue that many of the benefits are enjoyed by society at large.

There also are those who hold the view that accounting standards may impose costs on society at large, or on significant segments of it, and, therefore, the Board should assess the potential economic and social consequences of its actions.

The Board is keenly aware of preparers' cost-benefit concerns, and we consider them as we deliberate issues and subissues within the projects before us. In the interest of advancing the dialogue on these subjects and the related issue of neutrality of accounting standards, we have pulled together in this Special Report nine discussions of the issues that we believe to be directly on point. The discussion often reflects widely different viewpoints and perspectives, but our hope is that this compendium will stimulate further thought and writing on these difficult issues.

Norwalk, Connecticut
November 1991

Dennis R. Beresford
Chairman

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THE ROLE OF COST-BENEFIT CONSIDERATIONS IN THE FASB'S STANDARDS-SETTING PROCESS

Diana J. Scott and Wayne S. Upton

The stated mission of the FASB is to "establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information." In fulfilling that mission, the Board focuses on the relevance and reliability of existing financial information and of proposed improvements to that information and strives to achieve comparability and consistency in accounting for similar transactions. An underlying consideration, however, is an assessment of whether the expected benefits of issuing a standard that would improve financial accounting and reporting justify the anticipated costs of applying such a standard. Recognizing that cost-benefit assessments are not quantitatively precise but, rather, reflect the judgment of the standards setter, the FASB's mission statement requires that the Board strive "to determine that a proposed standard will fill a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits."

Nevertheless, critics often assert that FASB pronouncements fail a cost-benefit test. One reason for the criticism is that there generally is no clearly "right" answer to the issues the Board addresses. Thus, setting accounting standards involves making a choice among alternatives, each of which has a unique mix of perceived costs and benefits. Those perceived costs and benefits reflect judgments about the consequences of each accounting alternative, and, like all evaluations, judgments will vary from one observer to the next.

Those judgments are affected by a major portion of the costs of a standard being borne by individual members of the financial reporting community—primarily financial statement preparers and auditors—whereas the benefits are primarily recognized by financial statement users, whose costs of utilizing the information are not nearly as significant. In other words, one entity bears a cost, while others gain a benefit. Consequently, it is not surprising that, for ex-

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ample, a company may view its cost of applying a standard as exceeding the benefits it derives from the resulting information. On the other hand, the shareholders who ultimately bear that cost may believe that the benefit they derive from the information outweighs the cost they have borne.

There is no doubt that constituents face very real and, in some cases, very significant costs in understanding and implementing the Board's pronouncements. Through the Board's normal due process, information is obtained about the expected benefits and costs of changing existing accounting practice or standards. Constituents from all sectors of the financial reporting community have the opportunity to comment on Discussion Memorandums, Invitations to Comment, and Exposure Drafts of proposed standards, and to participate in public hearings. This process of soliciting and obtaining comments gives the Board considerable information about the costs and benefits of various accounting alternatives from the perspective of preparers, users, and auditors.

However, information about the costs of a new FASB pronouncement is usually anecdotal and inexact. It is anecdotal because it unavoidably reflects individual estimates of cost. It is inexact because it reflects estimates of doing things—gathering, processing, understanding, and using information—that have not been done before.

The Benefits, Costs, and Consequences of Accounting Standards

The Benefits

Why have accounting standards at all? The simple answer is because capital markets function more efficiently and corporate governance and regulation are more effective with credible financial reporting. SEC Chairman Richard Breeden summarized the objectives and benefits of financial reporting standards in the following statement to Congress:

> The purpose of accounting standards is to assure that financial information is presented in a way that enables decision-makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to a fair and accurate presentation, they fail in their purpose. This may also become the camouflage for improper and unsafe practices. Because of these dangers, all publicly-held companies, including financial institutions, should be required to adhere to a uniform set of accounting

principles. The principles should be established through a standard-setting and review process, overseen by a single agency, that is immune to tampering by a failed industry or its regulators.[1]

Financial reporting provides a benefit by presenting information that decision makers find useful. Stated differently, the benefit from financial reporting lies in its ability to make a positive difference in reaching decisions. The objective is to provide information that will assist in making those decisions and the resulting allocation of resources more effective. As evidenced by a 1987 research study published by the Financial Executives Research Foundation, credible and relevant financial information is the primary source of that information. The research study found that annual reports are the most used source of information by both individual investors (59.3 percent) and professional investors (84.6 percent) and that within the annual report the income statement and balance sheet are the most important sections.[2]

Credibility and usefulness are judgments that users make about the quality of information reported in financial statements. Their evaluation depends not only on the quality of the information that goes into the statements, but also on the manner of the presentation and completeness of that information. No single organization ensures that financial statements will be credible and useful. All members of the financial reporting community—financial statement preparers, auditors, investors and analysts, accounting standards setters, and regulators—have a role to play.

The objective of financial reporting standards is to provide a framework that governs the preparation of general-purpose financial statements. That framework of standards and practices, commonly referred to as generally accepted accounting principles (GAAP), produces financial statements that are more use-

[1]Richard C. Breeden, "Concerning Issues Involving Financial Institution Accounting Principles," Testimony before the Senate Committee on Banking, Housing and Urban Affairs, September 10, 1990.

[2]SRI International (formerly Stanford Research Institute), *Investor Information Needs and the Annual Report* (Financial Executives Research Foundation, 1987), pp. 35, 55. The study went on to report that the footnotes to the financial statements are the third most important section of the annual report to professional investors and the eighth most important to individual investors and that the sources and uses of funds statements are the fourth most important section of the annual report to professional investors and the third most important to individual investors.

ful and relevant than would exist in the absence of standards. Financial reporting standards provide:

- A reasonably standardized package of information, allowing market participants to identify differences among entities and to discriminate in investment and lending decisions on the basis of those differences
- Information that is useful in corporate governance
- Information that can be used in controlling contracts and government regulation and that often underlies economic policy

Standardized Information

Standards of financial reporting ensure a reasonably structured and standardized presentation of that information. Credible financial reporting enhances the marketplace's communication of information. However, although all market participants have access to a common level of information, not all market participants will use the information in the same way. Some will seek more information, while others will rely on summary indicators like earnings per share. Some will place great weight on a particular measure or disclosure, while others will give little attention to the same item.

The structured ordering of information mandated by financial reporting standards aids the market participant's ability to evaluate information systematically. The use of computer data bases and screening systems is a recent example of this systematic approach. Financial analysts and others increasingly use computers to review data bases of financial information in search of investment candidates. Lenders establish credit evaluation benchmarks based on ratios and other information drawn from financial statements. The success of all those approaches depends in large part on the availability of information in a reasonably standardized form.

Corporate Governance

Financial reporting standards also play a role in corporate governance. A corporation's management is the agent of shareholders. However, management controls most of the information that shareholders might use to evaluate its performance and may have a natural incentive to provide shareholders with information that presents the enterprise's performance in a favorable light. Financial statements that are prepared in accordance with standards that mandate measurements and disclosures thus serve as a tool that shareholders can use to better monitor management's performance.

Regulation and Contract Control

Finally, there is an advantage in having a common base of standardized information from which lenders, regulators, and others can obtain information to meet their specific data requirements. Financial reporting standards provide a base for contract control and government regulation and for developing economic policy. Lenders negotiate loan covenants, based on information drawn from the financial statements, to govern the behavior of borrowers and increase the security of loans. Government regulators rely on financial information in exercising their oversight of various industries. Published financial information provides the basis on which economic policy is developed. Both lenders and regulators can, and often do, require more or different information than that mandated by GAAP. Without a body of standards, lenders would be forced to negotiate each set of covenants "from scratch." Regulators would have to create their own comprehensive sets of accounting rules rather than simply identifying supplemental rules or departures from GAAP.

The Costs

What, then, are the costs against which benefits must be balanced? A footnote to paragraph 26 of FASB Concepts Statement No. 6, *Elements of Financial Statements,* defines cost in the following terms:

> *Cost* is the sacrifice incurred in economic activities—that which is given up or forgone to consume, to save, to exchange, to produce, and so forth. For example, the value of cash or other resources given up (or the present value of an obligation incurred) in exchange for a resource measures the cost of the resource acquired. Similarly, the expiration of future benefits caused by using a resource in production is the cost of using it.

By focusing on the amounts of cash or other resources given up, this definition captures the typical accounting notion of cost. The definition also captures what many envision when they refer to the cost of an accounting pronouncement. They see cost as the amounts expended to understand the new accounting requirements, develop new systems, capture new information, and maintain compliance. However, the cost of an accounting pronouncement also includes opportunity cost—the cost of consuming resources in alternate courses of action. Unfortunately, those costs are very subjective and cannot be consistently quantified in any meaningful way.

Every cost incurred is a sacrifice by some individual or entity. A new financial reporting standard creates costs for all members of the financial reporting community. Those costs, by and large, cannot be transferred directly to the beneficiaries of the financial information. For example, financial statement analysts do not share in the preparer's cost of providing the information from which they make investment recommendations. The choices made by standards setters create differing distributions of cost, but the choices rarely reflect direct trade-offs. There is seldom a set of alternatives that would reduce preparers' costs with a concomitant increase in cost to financial statement users. Nor are costs borne in the same way by all members of a particular group. A new pronouncement might impose costs on all companies in an industry, but the relative costs to individual companies may vary considerably.

Costs Incurred by Financial Statement Preparers

Financial statement preparers often express concern about the cost of complying with financial reporting standards. They also are the most active participants in the Board's due process, usually providing the great majority of comments received. Their comments sometimes include estimates of the initial direct costs of adopting the proposed standard (training, modification of systems, renegotiating contracts) and the ongoing costs of compliance (monitoring compliance, data collection, professional fees). However, their estimates often vary considerably. For example, one Fortune 10 company testifying about the costs of a new standard on accounting for income taxes estimated the cost at "one-half a man year to administer the rule." Another Fortune 10 company, testifying on the same day, estimated "the ongoing effort to require the equivalent of forty full-time employees, costing five to six million dollars annually."[3]

Financial statement preparers also identify other consequences that arise from new financial reporting standards. They include management's expectations about changes in a company's cost of capital, ability to comply with regulatory guidelines, and even its attractiveness or visibility as a takeover target. Wage settlements and executive compensation also may be affected. Finally, company managers often assert that a particular standard will create incentives to enter into or avoid certain transactions. Managers see this as a cost because they believe that accounting is causing them to pursue a different course of action than they otherwise would take. However, the FASB considers those con-

[3]FASB public record on Statement of Financial Accounting Standards No. 96, *Accounting for Income Taxes* (Stamford, CT: FASB, April 1988), pp. 2950, 3136.

sequences only to the extent necessary to ensure that a proposed accounting standard is evenhanded. Beyond that, the neutrality precept prevents the FASB from taking actions that favor one special-interest competitor over another or over the public interest.

Interestingly, these "cost" consequences mirror the benefits of financial reporting. The benefit of financial reporting resides in its power to improve the allocation of resources. That benefit is of little comfort to the manager who finds that a new accounting standard reduces the company's reported income and increases borrowing costs. That manager sees a very real cost and precious little benefit from that standard.

Costs Incurred by Auditors

Auditors incur direct costs that are similar in many ways to those borne by financial statement preparers. Auditors frequently incur start-up costs as they develop new procedures and train personnel in the requirements of a new standard. They may also incur ongoing costs associated with additional work needed to audit compliance. Auditors sometimes assert that they are unable to recover these costs in an increasingly competitive market for professional services.

The comments of auditors about the costs of complying with a pronouncement frequently echo the comments of financial statement preparers, with two important additions. First, without detailed requirements, auditors face the inevitable conflict of countering aggressive interpretations of accounting standards by some clients who take the position "if the standard doesn't say I can't [use a specific methodology], I must be able to [use the methodology]." Second, in today's litigious environment, auditors see the possibility of lawsuits as a very real cost. They are especially attuned, therefore, to the effect that a financial reporting standard may have on their perceived exposure to litigation. As a result, auditors frequently suggest including more detailed and specific provisions in a pronouncement. By narrowing alternatives, auditor judgment is reduced—a consequence that auditors often view as a benefit.

Costs Incurred by Financial Statement Users

Financial statement users—including individual shareholders, financial analysts and other intermediaries, lenders, government regulators, and elected officials—are the most diverse of the groups affected by financial reporting standards. This diversity makes user costs especially hard to gauge.

Financial statement users, such as financial analysts, incur start-up costs similar to those of preparers and auditors. Since analysts often use summaries of

previously issued information, they may incur significant costs in adapting that data to a new pronouncement. They, too, must train personnel and adapt to new disclosures and measurements.

Financial statement users also may incur indirect costs when accounting standards fail to prescribe standardized treatment of accounting information. Whereas preparers and auditors generally incur costs of inclusion—costs that result from what a pronouncement requires, users may incur costs of omission—costs that are consequences of what a pronouncement fails to provide. Financial statements that present inconsistent or incomplete information or that obscure differences between companies impose a very real cost on financial statement users. In some cases, it is the cost of recreating or modifying published information. In other cases, it is the lost opportunity cost—the cost of decisions that would have been different had the relevant information been available.

Other Consequences

Some commentators also maintain that a financial reporting standard will have consequences that go beyond just the cost of compliance. For example, some companies may make uneconomic business or societal decisions to produce a desired accounting result. As evidence of the possibility of societal consequences, some commentators on postretirement benefit accounting suggested that companies would cut back or eliminate postretirement health care benefits in the face of a requirement that they recognize the cost of those benefits on an accrual basis. Those who took that view suggested either that the cost of health care would shift from employers to government or that many retirees would go without adequate health care.

Another "cost" that might affect preparers, users, and society is the disruption created by change. The Board recognizes that disruption of the financial reporting system diminishes, for a time, the usefulness of financial reporting. The fourth guiding precept in the Board's mission statement states, in part:

> The Board considers it desirable that change be evolutionary to the extent that it can be accommodated by the need for relevance, reliability, comparability, and consistency.

For many constituents, the direct incurred costs of a pronouncement are minor when compared with the consequences of new requirements. A manager is likely to consider lower reported income and higher borrowing costs as very real "costs" of a new FASB pronouncement. The Board expects that its pronounce-

ments will have consequences; without consequences there would be no reason for financial reporting standards. How, then, does the Board consider the consequences of its pronouncements?

The Board can and does take steps to minimize the disruption created by new accounting standards. The consequences of change may lead the Board to slow the pace of change but not its direction. This was the case in the Board's pronouncements on accounting for pensions (Statement 87) and other postretirement benefits (Statement 106). Both of those Statements were acknowledged to be evolutionary steps rather than revolutionary departures.

However undesirable the consequences of accounting pronouncements may be for individual entities or an industry, they are the natural result of improved financial reporting. Any attempt to mitigate those consequences, altering the accounting to improve reported results, would undermine the credibility of financial reporting and thus its usefulness. To be useful, financial information must report economic activity without coloring the message it conveys to influence behavior in a particular direction. It must not intentionally favor one party over another.

Like census data, measures of national income, or SAT scores, financial statements should provide evenhanded data to all decision makers interested in financial information. One need only look to the collapse of the thrift industry to demonstrate the consequences of abandoning neutrality. During the 1970s and 1980s, regulatory accounting principles (RAP) were altered to serve other goals. Many argued that generally accepted accounting principles (GAAP) would force regulators to close institutions. They alleged that institutions using GAAP would be unable to compete in development and commercial lending. With RAP, regulators had an opportunity to forestall action, buying time for a hoped-for turnaround.

Most people condemn information slanting and bias, even when done by a government agency to further a national goal. As a private entity, the FASB has neither the authority nor the competence to assess the relative priorities of various and often conflicting national goals. Nor does the FASB seek that authority or that competence. Its sole mission is to improve, through accounting standards, the usefulness of financial statements so that decision makers, public and private, can make more informed decisions. The Board also understands that managers will sometimes alter their behavior in response to a new accounting pronouncement. This too seems a natural result of reporting information. If the information had no consequence, if it did not change the way markets and shareholders evaluate performance, it would have little benefit.

The Standards-Setting Process

To understand the Board's ongoing consideration of the costs and benefits of existing and contemplated pronouncements, it is important to understand the standards-setting process. That process begins with a decision to add a project to the Board's agenda ("the agenda phase"), followed by lengthy deliberation of alternative approaches to resolving the identified accounting issue ("the deliberative phase"). The process peaks with the issuance of a pronouncement setting forth the prescribed accounting for and reporting of that issue ("the final analysis") but does not end there. Rather, the process continues as the Board monitors the application of its pronouncements on an ongoing basis ("the post-issuance phase"). Throughout each of these four phases of the standards-setting process, a critical assessment is made of the benefits to be gained versus the costs and consequences of the accounting standard.

The Agenda Phase

The consideration of whether a specific project should be added to the Board's agenda usually is initiated by the Board's constituents—preparers, auditors, and financial statement users—and sometimes by the SEC or other regulators. There are basically four reasons a project might be added to the FASB's agenda. First, a new accounting standard might be considered to adapt to new transactions or changing economic events. For example, the current projects on financial instruments were added to the Board's agenda in 1986 because of the many new and innovative financial instruments and transactions that have evolved.

A second reason for adding a project to the agenda is to change existing standards, to correct perceived inequities, or to reduce the complexities involved in applying them. The Board's income tax project was added to the Board's agenda in 1982 to try to simplify the accounting for income taxes and to improve the understandability of the financial reporting, particularly with respect to deferred tax credits appearing on companies' balance sheets.

Third, a new standard might be sought to ensure consistency in accounting practice. For example, FASB Statements No. 87, *Employers' Accounting for Pensions,* and No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* were the result of projects undertaken because of the diversity of practice that existed in accounting for those transactions.

And finally, a project might be added to the Board's agenda to improve the general understandability and comparability of existing transactions or of pub-

FASB constituents do not always favor the alternative with the lowest compliance cost. Respondents to FASB Exposure Drafts sometimes advocate more costly approaches because they favor the accounting answer that the alternative produces in their situation. Statement 87 includes several provisions designed to defer recognition of experience gains and losses and reduce the volatility of reported amounts. Those provisions increase the complexity of accounting for pensions and, as a result, increase the costs of following the standard. Nevertheless, those delayed recognition provisions were favored by many companies because they viewed the result as being more desirable.

2. *The one-time costs of implementation and the ongoing costs of compliance.* Implementing a new accounting standard by its very nature imposes one-time costs of changing from old to new ways in addition to the ongoing costs of applying the standard. The Board's consideration of the initial costs of implementation includes not only the cost of understanding the new accounting and developing the data necessary to apply the standard, but also consideration of any transitional effects of accounting for the change in accounting principle. When the transitional effect of the change in accounting is likely to be significant, as for example with the implementation of Statements 87 and 106, the Board may make a pragmatic decision to phase in recognition of the effect of the change over future periods. Similarly, consideration is given to the incremental ongoing costs of complying with the standard, such as the incremental data collection, analysis, and auditing costs.

In addition to information gathered through comment letters on proposed documents and public hearing testimony, the Board seeks information about the costs of applying a standard from a number of outside sources, including the following:

- Regular consultation with the Financial Accounting Standards Advisory Council (FASAC)
- Consultation with FASB task forces appointed to assist the Board during the course of a project
- Meetings with representatives of industry and professional groups that monitor FASB activities, including trade association committees, committees of public accountants, and so forth
- Consultation with accounting personnel from entities that have experience in particular areas

- When justified, formal field tests of proposed standards conducted by groups of constituents and monitored by Board members and staff
- Less formal test applications or special studies of all or part of a proposed standard conducted by selected companies

Based on the information obtained, the Board, using its best judgment, then must assess whether the benefits to the company and the users of its financial statements warrant the cost of the new accounting standard. The Board recognizes, however, that not all of the costs that accompany adoption of a new pronouncement are necessarily the product of the pronouncement. Some costs may be more appropriately associated with the cost of managing the affairs of the reporting entity. For example, in paragraph 126 of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* the Board observed:

> Many employers have not monitored and managed their postretirement benefit obligations and costs. Consequently, a significant portion of the incremental systems cost reflects costs that a prudent employer would incur in monitoring and managing the consequences of its postretirement benefit arrangement. The Board believes that those costs should be associated with the existence of those arrangements, rather than with the requirements of this Statement.

These comments do not imply that the Board produces standards of management behavior. Shareholders, or in the case of not-for-profit organizations, contributors, will evaluate management's stewardship. However, information used for financial reporting often emerges from the same base of information needed to manage an entity's operations and resources.

3. *Alternatives that might decrease costs.* The Board often considers approaches that might reduce the costs of compliance while meeting the objectives of measurement or disclosure. For example, the Board adapted some of the provisions of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* to use information already gathered for reporting to banking regulators. Pronouncements sometimes identify situations in which shortcuts or approximations may be used to reduce the costs of compliance.
4. *Balancing the costs and benefits of sufficiently detailed guidance.* Observers often criticize the FASB for providing too many detailed rules, too much

guidance. They sometimes characterize a pronouncement as a "cookbook" and maintain that this creates additional costs of compliance. The Board tries to avoid overly detailed guidance, but some level of detail is necessary to ensure that a pronouncement will lead to consistent application among reporting entities.

For example, a pronouncement might simply specify that entities use "an appropriate rate of interest" in performing a measurement. That would be general guidance, but it would likely lead to considerable diversity. One entity might select the rate on U.S. Treasury securities. Another might use its average or incremental cost of borrowing. The resulting diversity would diminish the usefulness of financial statements. Providing more specific guidance about how individual entities should select the rate to be applied to their own circumstances ensures that, to the extent possible, differences will reflect variations among individual situations. The Board does not consider that guidance excessively detailed. While this kind of guidance generally would not impose any incremental cost of significance, it does mitigate the need for subjective assessments that would permit companies to "manage" their earnings.

There is also a hidden cost when a pronouncement fails to provide enough detailed guidance. Returning to the example above, a pronouncement that simply called for "an appropriate rate" would impose additional costs on preparers, auditors, and users. Preparers would be forced to interpret and apply the general rule to their situation and then to justify their application to independent auditors. Users would have to devise ways to adjust the measurement to put companies on similar bases for comparative purposes. Those costs are not as clearly evident as the costs of complying with more specific requirements, but they are costs nonetheless.

5. *The level of disclosure necessary to enhance the understandability of the financial statements.* Disclosures often provide supplementary information that enhances the financial statement user's understanding of the nature and implications of amounts recognized. Sometimes, disclosures are designed to compensate for not following conceptually defensible and preferable accounting methods. For example, certain disclosure requirements of Statements 87 and 106 are designed to compensate for the delayed recognition afforded gains and losses in the measurement of an employer's obligation or plan assets as a result of changes in assumptions and from experience different from that assumed.

Lengthy or detailed footnote disclosures, whatever the reason, are often viewed as unnecessarily increasing the costs imposed by an FASB pronouncement. The Board acknowledges that disclosure, like any requirement of a pronouncement, imposes some costs, but notes the role of financial statements in providing information that is useful to a wide range of user interests. The FERF Research Report referred to earlier observes that, although companies view footnotes as "important to analysts and ignored by individuals [individual investors]," in fact, more than 90 percent of professional investors and 40 percent of individual investors view them as important to getting an accurate picture of a company's performance.[4]

The value of certain disclosures is initially assessed on an individual basis in light of different users' perspectives and then is evaluated as a whole. Frequently, the Board observes that, while the benefits of individual disclosure requirements seem to warrant the incremental costs of providing that information, the aggregation of the costs of providing the "package" of disclosures is judged to be excessive. Consequently, the Board may decide to eliminate certain disclosures that are judged not to be as generally useful as others or to minimize the costs of disclosure by utilizing information already gathered or that is readily available from the measurements required for recognition purposes.

6. *Transition approaches that reduce cost and minimize disruption.* Transition provisions provide an opportunity for the Board to minimize the implementation cost or disruption caused by a pronouncement without affecting the nature or direction of change. The Board attempts to treat transition as a practical matter to the extent possible. Accordingly, the Board may choose one or more of the following transition approaches:

   - Allow an extended period before companies are required to apply all or part of a pronouncement. This gives the financial reporting community time to assemble information and build skills before first applying a new standard.
   - Apply the pronouncement only to transactions entered into after a certain date. This removes the need to remeasure existing assets and liabilities and to gather information about older transactions.

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[4]SRI International, *Investor Information Needs and the Annual Report*, pp. 45, 55. Refer also to footnote 2.

- Allow transition alternatives. This gives entities the opportunity to choose the transition approach that management considers the best for the individual entity. Transition alternatives are controversial, especially among financial statement users. However, alternatives allow some entities to select the "best" approach without imposing additional costs on all financial statement preparers.
- Allow transition amounts to be recognized over time. This minimizes the disruption that might be caused by a sudden change from old to new accounting methods.

All of these approaches, however, impose a cost on users.

The Final Analysis

Each Board member must ultimately decide whether, in the Board member's judgment, a pronouncement, taken as a whole, sufficiently improves financial reporting to justify the costs it imposes. Board members make this final cost-benefit judgment each time an FASB pronouncement is balloted for issuance. There is no tally sheet to which the Board member can refer. Rather, the decision rests on the Board members' own subjective judgments that a standard would provide benefits—in the form of improved financial reporting—that exceed all of the various costs imposed.

The Postissuance Phase

The Board has several tools with which it monitors the consequences of its pronouncements. For example, implementation task forces may be established following issuance of a standard to consult on questions or problems that arise in implementing a standard. Another source of postissuance monitoring is consideration of the nature of the inquiries and comments the Board and staff receive from preparers, auditors, and financial statement users following issuance of standards. As was the case with FASB Statements No. 95, *Statement of Cash Flows,* and No. 96, *Accounting for Income Taxes,* this information sometimes causes the Board to alter a standard or to reconsider its decisions. From time to time, the Board has commissioned research studies designed to identify the consequences of pronouncements.

Implications of Cost-Benefit Considerations on Small Businesses and International Competitiveness

Two areas deserve special attention in a discussion of the costs and benefits of financial reporting standards—the effect of standards on small businesses and the international implications of financial reporting standards.

Small Businesses

Commentators have observed that the effects of any regulation, including accounting standards, fall disproportionately on small companies and organizations. These entities, which typically have limited staffs and resources, incur a greater relative cost than their larger counterparts. This has led some observers to suggest that the cost-benefit scale should be applied differently to small entities. They suggest a variety of solutions, most of which focus on special exemptions to be provided to small businesses.

The Board has acknowledged the relative burden that its pronouncements impose on small entities—both businesses operating for a profit and not-for-profit organizations. It makes special efforts to identify those burdens and include them in its consideration of costs and benefits. In some cases, the Board has exempted nonpublic companies from disclosure requirements. In other cases, it has provided additional time before smaller entities must adopt new pronouncements. In general, however, the Board has not considered special exemptions from standards of recognition and measurement to be in the best interest of financial reporting.

Differential standards might reduce costs for exempted entities, but they would increase the costs of accounting standards to the financial reporting community as a whole. Financial statement preparers, auditors, and users would incur the costs of learning and applying two sets of standards. The often-cited "accounting standards overload" would be increased. Financial statement users would incur additional costs in analyzing and understanding small company financial statements, especially if the use of differential standards were optional. In addition, the Board notes that users of financial statements of publicly held companies have many possible sources of information, including the work of financial analysts. The same sources of information are generally not available for smaller nonpublic entities. The general-purpose financial statements may be the only source of financial information. This suggests that, while the costs of accounting standards may weigh more heavily on small businesses, the benefits to users also may be greater.

International Considerations

Some observers have suggested that financial reporting standards in the United States impair the effectiveness of domestic companies in international markets. Critics suggest that the cost of complying with U.S. standards discourages non-U.S. firms from raising capital in the U.S. market, thereby diminishing markets for domestic underwriters. Some observers argue that the cost of our standards on U.S. businesses is an overhead not borne by their foreign competitors. Others suggest that there is little incentive for a foreign company to make potentially unfavorable disclosures when the information is not required by the accounting standards in their country. Some also maintain that U.S. disclosure standards reveal information to foreign competitors, while domestic companies cannot gain the same information about foreign firms.

The Board considers international implications as part of its consideration of proposed pronouncements. FASB Chairman Dennis Beresford addressed the problems of financial reporting standards in an increasingly international market in an article titled "Financial Reporting: Comparability and Competition."[5]

His comments deal with many of the objections just described and go well beyond the scope of this paper. In the final analysis, though, the problems of foreign competition and foreign resistance to U.S. standards do not support a lowering of U.S. standards. The fact that securities markets in our country are more strictly regulated than in many foreign jurisdictions and that accounting standards are generally more stringent are burdens that have been imposed on domestic companies by policymakers in the pursuit of greater capital market efficiency.

SEC Chairman Breeden observed that:

> The dramatic collapse within the past two years of the centrally planned economies of Eastern Europe and the Soviet Union has clearly demonstrated the superiority of the market economy as a model for the greatest economic growth. Many nations are now scrambling to establish or enhance a "market" economy. Ironically, sometimes we may take for granted essential factors in the functioning of our market economy, such as the integrity of our accounting system.
>
> An essential element for the efficient functioning of our market economy is the availability of relevant and reliable financial information. Millions of participants in the market depend on this financial

[5]FASB *Viewpoints*, November 8, 1990.

> information and the system of accounting principles that underlies it to make everyday operating decisions and long-range strategic plans. These participants include those who seek capital to expand their enterprises or embark on new ventures, and those who through investment risk their savings to provide that necessary capital in the expectation of sharing in future returns. The accounting profession (including both practitioners and standard setters) and the Securities and Exchange Commission have a strong common interest in maintaining the integrity of our system of accounting principles and in ensuring that it remains the irreproachable standard of excellence for the world.[6]

Conclusions—Costs and Change

It is the nature of financial reporting standards that costs are borne by individual members of the financial reporting community. Benefits may accrue to individuals and entities—the benefits of better decisions made with better information. Benefits are also more widely dispersed to the capital markets as a whole.

It is also in the nature of financial reporting standards that the costs that accrue to some parties versus others are disproportionate to the benefits received by all those parties. There is a fundamental tension between those groups that affects the relative weights they apply to costs and benefits. A financial reporting standard represents a loss of management control over information—loss of the ability to decide whether, when, or how to present information. In the final analysis, any proposed standard is likely to trigger a new battle in a continuing struggle over information.

The Board's mission is to improve the usefulness of financial reporting. Accomplishing that mission requires change, and change, by its nature, imposes a cost. The costs of change, both direct costs and less tangible indirect costs, may lead the Board to slow the pace of change. Change must continue, however, if financial reporting is to play the role for which it was originally conceived—to improve the function of the marketplace by providing useful information.

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[6]Richard C. Breeden, "Accounting in a Rapidly Changing World" (Remarks at the AICPA's Eighteenth Annual Conference on Current SEC Developments, January 8, 1991).

ARE COSTS-BENEFITS MEASURABLE?

Editor's Note: On April 24, 1990, the Financial Accounting Standards Advisory Council, made up of persons from industry, banking, public accounting, the legal profession, and academe, discussed at length the measurability of costs and benefits and the weight that should be given to those considerations in standards setting. Persons quoted in the following excerpts from the discussion of costs and benefits are identified by full name and affiliation (at the date of the meeting) on page 35.

Excerpts from Background Paper

The Board's mission statement includes the following basic precept that the Board is expected to follow in its work:

> **To promulgate standards only when the expected benefits exceed the perceived costs.** While reliable quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will fill a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits.

There is no question that businesses face real and sometimes significant costs in studying, implementing, and using new standards, and they frequently express concerns about whether those costs are warranted.

At a small dinner meeting in May 1988 with several Board members, the chairman of FASAC, the FASB director of research and technical activities, and several others, John Reed, CEO of Citicorp and chairman of the Accounting Principles Task Force of the Business Roundtable, stated that the Board does not properly weigh potential benefits of its actions against their potential costs. He mentioned not only the out-of-pocket costs of implementing new standards but also their economic and social consequences. He subsequently suggested that assessing potential consequences could be the responsibility of a group other than the FASB itself.

This chapter comprises excerpts from a background paper prepared as a basis for discussion and meeting transcript, Financial Accounting Standards Advisory Council, April 24, 1990.

Most observers recognize that measuring both costs and benefits is elusive at best—especially when benefits are expected in the future and are characterized as serving purposes such as "fairness," "comparability," "the public interest," and other essentially unmeasurable factors. Some have also observed that the costs fall disproportionately on preparers, while the benefits are more widely dispersed. How then, in short, can meaningful information about costs and benefits be obtained, and how can resulting assessments include the "costs" of *not* providing certain information that is generally thought to be desirable?

What Are the Costs of a New Standard?

Costs, it can be argued, include:

- Developing a standard, including costs of participating in the process
- Educating preparers, auditors, and users
- Implementing and maintaining required systems to collect and process information or other accounting changes that the standard might require
- Auditing the systems and resulting information
- Disseminating the information
- Analyzing and interpreting the information
- Legal and competitive exposures that grow out of making information available
- Information overload—giving a user more than can be assimilated—which may prove to be a hidden cost

What Are the Benefits?

Benefits can be said to include:

- Maintaining and improving the credibility of financial reports, which is a critical part of public confidence in financial markets
- The increased utility a user—lender or investor—gains from the improved flow of accounting information, including the ability to select better among various investment options
- The increased knowledge a preparer gains about the financial position and results of the organization
- Increased credibility of an entity's financial data and resulting improved accessibility to capital markets, very possibly at lower cost

The dilemma of the cost-benefit relationship is not exclusively that of accounting standards setters, and the problem was discussed in an April 4, 1990 article in *The Wall Street Journal* dealing with the inability of federal regulators and legislators to cope satisfactorily with the billions of dollars of cost-benefit factors as they applied to the Clean Air Act then under consideration.

A group of consultants to the federal government's Cost Accounting Standards Board delved into this issue and outlined the problem in a 1978 report, which noted:

> Our conclusion is that no objective cost benefit in aggregate quantitative terms is possible for CASB standards as a whole or for any of them individually. Reasonable people, with some experience in such matters, acting responsibly in a spirit of compromise, using such reliable information as can be gathered together, will make a "calculation," as they must if anything is to be done. But the calculation will be in ordinal rather than cardinal terms; it will be rough rather than precise; it will always be subject to revision, rather than fixed in stone. The situation is not different from that concerning the merits of many other laws, rules, regulations, and administrative decisions.

Thus, these costs and benefits, difficult as they are to measure, represent only a start and, as noted above, do not take into consideration the costs saved and benefits lost by *not* issuing a particular standard that may be required.

Excerpts from Meeting Discussion

Mr. Kolton: Are costs and benefits measurable? This question surfaces with virtually every Board project. Indeed, the Board's mission statement makes clear that standards should be issued only when the benefits of those standards exceed their costs. Periodically, the Board is charged with failing to achieve this objective.

There is general agreement that a formula or technique for measuring costs and benefits is neither as easy nor as self-evident as one might wish, and it's compounded by the fact that articulate people on both sides of the issue frequently don't agree on some basic definitions of what costs are to be measured and what benefits are supposed to be evaluated.

Bob Swieringa has thought about the cost-benefit question for some time, both as a Board member and before that as a professor. He will give us his views and then we will turn to some of the specific questions.

Mr. Swieringa: I think the background paper describes the issues well. I would like to provide some examples and then conclude with some observations. I'll pull the examples from standards that have been developed during my time at the Board because in that sense I have some familiarity with some of these issues. The first one is Statement 89. This is not a quiz to have you remember what the content is of each of the Statements, but Statement 89 was superseding Statement 33 about inflation disclosures. Cost-benefit considerations were used to justify superseding Statement 33. A large research literature was available about the usefulness or lack of usefulness of those disclosures, and the Board cited that large literature as a basis for that decision.

Statement 91, which dealt with loan fees, is another interesting example of cost-benefit. The Board initially decided to have a very limited definition of the costs that could be capitalized as part of the origination of a loan. The respondents to an Invitation to Comment had indicated that accounting systems that existed were not very reliable in capturing those costs, and the Board relied on those descriptions or assertions in developing an Exposure Draft that had a very limited definition of costs that could be deferred. So the Exposure Draft reflected this very narrow definition. The respondents to the Exposure Draft and individuals testifying at the public hearings asserted that those origination costs could be reliably measured, and they advocated that many more costs be capitalized and deferred. There was an extensive discussion at the hearings about that particular issue. In the final Statement, the Board allowed more costs to be deferred—in particular, certain costs directly related to specified activities performed by a lender were deferred as part of that standard. However, as the effective date approached, the Board received letters requesting more time to develop reliable systems to measure loan origination costs because we learned that there were many organizations that didn't have sufficient systems to record those costs. So here is one example of where, basically, the costs of having these systems and the benefits in terms of reliability was an initial focus, additional information was obtained, a change in decision was made, and then finally we found—with some remorse—that perhaps the information was not as complete as we might have thought.

Another example is in Statement 95, which dealt with the statement of cash flows. Cost-benefit considerations played a role in permitting the continued use of the indirect method of reporting net cash flows from operations. Research was commissioned by the Board to investigate the cost of using the direct method, which was suggested by many analysts and many members of The

Robert Morris Associates. This is a case where the Board in fact commissioned research to try to study the costs of using a direct approach and relied on those costs in some part in coming to a decision to permit the indirect method.

Statement 96, which deals with accounting for income taxes, relies on cost-benefit judgments and considerations at various points to try to make the accounting easier. Yet as the implementation group started out discussing these issues shortly after the Statement was issued, many of those particular cost-benefit decisions related to tracing of costs relating to transition, and a large number of the smaller issues in Statement 96 were second guessed. This in some ways is a very frustrating process, if you think in fact you make a judgment to try to be more efficient and effective in setting some of these provisions and then learn afterward that your batting average might not have been as good as some people in the major leagues.

Statement 101, which dealt with the discontinued application of regulatory accounting under Statement 71, also relied on cost-benefit considerations in justifying not removing the effects of regulatory accounting from plant property and equipment accounts in going forward on basically nonregulatory GAAP. This is a case where many of the regulated enterprises provided relatively detailed information about the cost of removing the effects of regulatory accounting, in particular the allowance for funds used during construction in intercompany profits.

More recently, Statement 104, which was an amendment of the cash flow document to allow some netting of deposits and the lending activity, also relied on cost-benefit considerations to allow banks, savings institutions, and credit unions to report net cash flows for certain deposit and lending activities. Cost-benefit considerations also were cited as justification for not allowing finance companies, insurance companies, and other financial intermediaries to report net cash flow for those activities.

Then finally, tomorrow we're going to talk about disclosure requirements for postretirement benefits, in particular, what disclosures should be provided about the obligation to provide postretirement benefits and the cost of providing those benefits. About 65 percent of the commentators on the Exposure Draft believe that the proposed disclosure requirements are too extensive, too complex, not cost beneficial, and add to an overall perception of information overload. The challenge we have is that, individually, when you go through the various disclosure requirements you can view them as being very useful—in fact as being essential. But in the aggregate, they are viewed by many as being excessive, and the challenge is to try to decide which ones should be included and which ones should be excluded.

Let me turn then to several observations. The first is that information obtained about costs and benefits is suggestive rather then definitive. We receive information from various sources in a sequential process, and we use this information to form judgments. Sometimes the information we obtain complements other information, sometimes it is contradictory, and we essentially rely on a sequential process of trying to sort out this information, but it is suggestive rather than definitive.

Second, decisions to obtain more definitive information about costs and benefits are themselves cost-benefit judgments. In fact, that's really the question that is being posed here. How much research, how much additional analysis, should be undertaken to obtain this information?

Third, the cost-benefit judgments are subject to second guessing, as I pointed out with the income tax document and with several others. I believe that is, in part, because they are based on incomplete information. The dilemma is that the judgments that might be based on more definitive information also would be subject to second guessing, because no matter how hard we would work at it, the information still would never be complete. It is also difficult, I believe, to distinguish between cost-benefit judgments and judgments about economic consequences. If you went through the background paper there are various points where one could read the comments as being not just about cost-benefit but really about social or economic consequences.

Another implication or observation is, I believe, that parties who have information about costs and benefits sometimes share that information with us, sometimes they don't. In fact, in general I think there is a disincentive to share that information, unless sharing it is somehow in their own best interest. As an example, during the writing of Statement 96 on income taxes, we knew there were several companies that were working hard to early-implement Statement 96. We found out about them mostly afterward as we saw them adopt Statement 96 early. Yet it's clear that they probably had a significant amount of information about implementing Statement 96 that could have been shared with us. At least from our standpoint, it would be advantageous to have shared it.

And finally, cost-benefit considerations can sometimes conflict with other precepts that we have in our mission statement, in particular a desire to try to account for similar transactions in a similar way. To the extent that cost-benefit decisions are applied at the individual provision level—the level of individual provisions in a Statement—you might end up with a situation where companies that engage in exactly the same or very similar transactions essentially achieve different accounting, in part because of a cost-benefit decision.

Mr. Kolton: Let's turn to another aspect of the question for a minute. Steve Zeff, I think that most people would agree that as wispy as some of the costs are in estimating the development and implementing of a standard, it would be significantly more difficult to try to measure the cost of not developing a standard. Is there any way that the Board could get its arms around that?

Dr. Zeff: That's even harder. There are economic consequences and costs of just leaving things the way they are, let alone changing them. I don't know how one gets at those kinds of answers. They're speculations, they're company specific, they're industry specific, they're country specific, and I think we learn as we go on that sometimes the costs are greater or lesser than we thought. So it may turn out that our initial estimates were completely off. It's subjective, it's sequential, and it's very hard to anticipate these things, particularly since it's totally novel.

Mr. Kolton: Let me turn to Clarence Sampson. Clarence, with your previous hat on, the SEC hat, you certainly had to worry about the cost-benefit equation in SEC pronouncements. How did you approach it?

Mr. Sampson: I don't know that I can say anything much different than what I have heard others around the table say about the difficulty of trying to ascertain what those numbers are. The Commission, as I'm sure all of you know, had a very small staff and did not spend a lot of its own time trying to do that kind of empirical research—it simply couldn't—and relied on input from the public at large, the institutions that use the data, and the preparers. And the results were more or less satisfactory, depending upon the issue with which you were dealing. Occasionally we got some numbers that looked like they would be useful when making decisions. And occasionally the data that was furnished was in such a state that you really wound up making a subjective decision as to your feeling as to the costs and benefits and trying to convey that to the Commissioners as they made their decision.

Mr. Kolton: Thank you, Clarence. Ed Coulson, in terms of today's Commission, to what extent do you worry about this question of cost-benefit when you are working on a Statement?

Mr. Coulson: Well, I don't lose a lot of sleep, but it is an issue that must be considered. It's a difficult question and I think the response to the question—are they measurable—I think the answer is no. But that doesn't mean that you cannot consider it. You have to consider it seriously, taking whatever information

you have. The bottom line, I guess, is judgment based on the facts. I think an additional cost-benefit consideration (there is no empirical way to deal with this) that probably needs to be considered more and more as we have a more global environment, is the impact on American companies with respect to worldwide practice. That's a difficult issue to deal with. As to an issue that we will be discussing today, mark-to-market accounting, is it possible to go to widespread mark-to-market accounting for just companies that follow U.S. GAAP? That's a question, not a conclusion. Same with consolidation: Can you change consolidation rules so that it's out of sync with the rest of the world? Those are difficult considerations.

Mr. Kolton: Let me try to get a little more specific on getting a handle on the costs and possible benefits. Let me turn to Dennis Dammerman. As a practical matter, would an organization such as GE be able to respond to questions that the Board might ask about the expected costs and perceived benefits it expects to obtain from a proposed standard? If your feet were put to the fire on that one, how would you go about it? Or could you?

Mr. Dammerman: In terms of a specific company having to determine the cost to comply, yes, we can. In terms of hard data for all companies I don't know how we would ever get a good feel without a lot of work. I honestly think that in many cases the cost issue is a bigger issue for smaller companies and that we should have a lot of concern and take a lot of care in that regard. In terms of the benefits, they are clearly subjective. We are always going to have a different opinion of what the benefit may be, as Ed just mentioned a few minutes ago. Consolidations or mark-to-market in a global environment is a very difficult concept and one that takes on a whole range of issues that we tend not to think about. I think the thing that's critical, if you can't get hard cost data, I think the value of intense field tests, particularly on what are perceived to be initially complex standards, is critical. I think Statement 96 is a perfect example of what we are learning as we get into implementation. Now for us it happened to be relatively easy, because we have lots of credits sitting on the balance sheet. That helps. But given the incredible complexity that we've run into on that standard, some good field tests would have helped a lot, or better field tests. I think—having participated in the field tests on other postemployment benefits—while I may have some concerns about the direction of the accounting standard, having participated in the field test has been a tremendous benefit to us in terms of understanding the issues and how they are going to be presented from our perspective, and I have to believe it would be very helpful to the Board in that final pronouncement.

Mr. Colwell: First of all with respect to the costs, I think I'm pretty much where Dennis is. In certain instances as we have looked at proposed standards, we have estimated costs for our own use, or to be of assistance to us in commenting on a standard. Certainly to some extent they are broad estimates. But with the cost pressures that our businesses have today, it certainly is something that we pay a lot of attention to, whether it's for our internal use or whether it's to use in commenting on the standard. In any event, I think that we should be very willing to cooperate with the Board in any way that we could to assist in the cost evaluation because we feel it's of such critical importance. So, yes, we'll do anything reasonable to try to understand the costs of a proposed standard. With respect to benefits, it's much more subjective, very difficult. We don't have any easy answers to it. Again, we really can't do a reasonable job of commenting on a standard without subjective evaluation of benefits. So again, we would give that our best effort.

Mr. Meinert: You see a lot of medicines that say for external use only. I think that sometimes on disclosure you should just use the words "for *internal* use only." I think that many of these costs we talk about have to do with external disclosure, and it's not true that the company doesn't have the essence of that information already available. If they don't have it available, part of the benefit is to produce better information for management, so they would have it available and know what they are talking about. In some cases you have departments that have it available, and it's not always disclosed because sometimes it's embarrassing information. And I also think that on the benefits side we're getting some, well, what I consider plain threats. For example, if you make us do this we're going to produce a negative benefit: We'll take away loopholes, or we'll change our plans and so on. I think that some of these are just to frighten us off from true disclosure.

It seems to me that a question that many managers have is: Would I still do this if it had to be reported or if it had to be disclosed, and how do I feel about that? And I don't think that we'll ever get a true picture of the benefit side of it. But I think the cost side is highly overrated.

Dr. Weil: I think the whole enterprise of cost-benefit measurement is a hopeless undertaking. First, on the costs: We know enough about measuring costs to know that there are dozens of different ways to measure cost. We're talking about the cost of doing a standard, so do we mean fully absorbed cost, do we mean the start-up cost, do we mean the ongoing cost? Nobody has defined any

of these. Cost-benefit analysis—what we're supposed to be doing—I am not sure we all agree on how to measure it. We know how hard it is to measure costs of individual products in a multiproduct organization. It's not any easier here.

The worst part, in my opinion, of the cost-benefit equation is dealing with the benefits. How many of us 10 years ago would have been able to predict the use of in-car, mobile telephones? The information available to us now is that people are using a lot and not many people 10 years ago thought they would be very useful. How many lawyers 20 years ago could foresee what Lexis would do to the practice of law? How many accountants five years ago anticipated what NAARS would do for the practice of accounting? People, I believe, are not good estimators of the future benefits of information. When we try to measure benefits I think we're not going to get very far. My judgment is that if the Board's wisdom suggests a change in GAAP, I'd not like to see the Board fail to make the change because it cannot prove that benefits exceed costs.

I would prefer for accountants to have a clear picture of what accounting is all about. You may not agree with me that the major purpose of accounting is to measure or estimate the amounts, timing, and uncertainty of future cash flows, but I know how to evaluate proposed standards because I ask myself: Will this information make it easier for me to estimate the amounts, timing, and uncertainty of future cash flows? If the answer is yes, I don't care if you can't see it, I'm going to be for that standard. It will be my job to try and persuade you that there is information here that you didn't have before and that the analyst will be able to use that information in ways to make the capital markets more efficient. But just because I can't persuade you that five years from now analysts are going to find this information helpful in making assessments of future cash flows doesn't mean that's not the way we should think about it. I do not believe that we are good forecasters of the future value of information. We need, instead, a clear idea of what accounting is all about, then let's follow it and let us debate whether the disclosure proposed—the proposed measurement—is going to help us to go at it.

Mr. Kolton: I think it's time to turn now to several users. Milton Meigs, if you were asked to comment on the usefulness of financial information that the Board was considering asking for, wouldn't you try to couch your arguments in terms of what the benefits would be of that information, and if you could, how quantitative or qualitative would that information be and to what extent would you try to help the Board determine how to evaluate the usefulness that that standard is going to have?

Mr. Meigs: Well, as I think about this whole issue of the costs and benefits, I certainly agree that from a user's perspective—particularly in the grandeur of hindsight—it's really hard to anticipate those things.

Mr. Kolton: Pat McConnell, let me turn that question to you. If you were confronted with the problem of trying to persuade the Board that the benefits of something that the Board was proposing were going to be of significant value to the user, how would you address the benefit question—would you try to quantify it?

Ms. McConnell: The committee that I chair—the Financial Accounting Policies Committee of the AIMR [Association for Investment Management and Research]—has actually confronted this issue with the Securities and Exchange Commission. The Securities and Exchange Commission has an open proposal to require quarterly segment reporting. And we were told that what was needed to get that proposal finalized was a cost benefit study that demonstrated that the benefits outweighed the costs. And I believe that the economists at the SEC have gathered up the costs and they think they know what it costs, but they have no demonstrated benefits. And my committee for two years has been trying in various ways to demonstrate that benefits exist, and we have not been successful in finding any methodology that would provide a quantitative dollar amount of the benefit that quarterly segment reporting would provide. We had extensive discussions with numerous academics about how we would proceed because we were willing to fund a project, and we are in fact funding several academic studies, but they won't really quantify the benefits. They can perhaps demonstrate that there is a market impact of quarterly segment information, but they aren't going to be able to say that that benefit is greater than the cost, which apparently can be quantified because you can figure out the incremental cost of providing incremental information.

Mr. Dammerman: I agree that we can measure costs 43 different ways. I also know intuitively—I don't need anybody to measure cost for me—I know intuitively if I am a toothpick manufacturer the fact that a box goes out the door and holds approximately 250 toothpicks is close enough. And if you write a standard that tells me that I have to count each one of those before I can book sales, I know intuitively you're wrong. We are a bunch of reasonably intelligent people sitting around this table and I think cost-benefit as a concept—and I know it's squishy, I know both sides are squishy, the benefit and the cost—but thinking about it at least is an important part of the issue.

Mr. O'Brien: My comment springs from someone who has changed his mind on this subject, which may or may not be right. I started out after thinking about it with the opinion that it was very very important to have precise, definite guidelines related to cost-benefit analysis, because I just felt that things were, somehow, getting a little out of hand. Maybe because I was hearing people say that, but suffice it to say I've changed my mind, and I think that it is rather foolhardy, and it violates my sense of common sense in a way to try to be too precise on cost-benefit analysis. We will never agree on a standard for costs, and we can never foresee the benefits. Therefore, why try to become as precise as some people would have you think we should be? That is not to say that we should forget about it entirely. And I would say, therefore, in the mission statement that the better approach is to state it as a matter of principle rather than as an inviolate requirement.

Mr. Kolton: Roman Weil, let's go back to an earlier comment you made. You characterized this search for cost-benefits as a hopeless undertaking. Do you think in terms of a review of the mission statement that the whole concept ought to be abandoned, or is there another way to handle it?

Dr. Weil: I think it ought to be abandoned. When we talk about cost and benefits around here, I don't know what standards people have in mind. But I'm thinking—as this discussion proceeds—on the one hand if standards like mandatory consolidation and the cash flow statement, which I consider to essentially have no cost, anything I can teach my students to do in first year accounting using the external annual reports to approximate, I figure that is essentially a zero cost for a company to implement to a first order of approximation. Whether it benefits or not, I don't know. But I do know that people in the financial analysis world can derive those numbers and could have derived those numbers for themselves without the standards. On the other hand, we have OPEB. OPEBs are going to provide us with information not otherwise available to us, whether it's in disclosures or on the statements themselves. Once we get some numbers we're going to have estimates of future cash flows we would not otherwise have.

Those standards are so different one from the other that I don't see how to bring them all under a cost-benefit umbrella. Maybe as I said on the first case, the costs are small and the benefits are small. In the second case the benefits are large and unanticipatable and the costs are going to be hard to measure. What that leads me to believe is that the Board could change the mission statement to take the focus off this issue and put the focus on whether this standard provides

information that will enable the user—the consumer of the financial statements—to do what we say they should be doing, then we don't have to worry about putting numbers on it. Does the OPEB Statement provide information that users of financial statements cannot otherwise get and will find useful in assessing the values of the companies or the securities that they issue? You don't need cost-benefit analysis as developed by the RAND Corporation and Defense Department to do that.

Mr. McLendon: The sense of what I'm hearing around the table is that the mission statement might better read "To promulgate standards only when the expected benefits *appear* to exceed . . ." and then, instead of "the Board strives to determine," "the Board considers." I don't think we want to leave the principle, but perhaps it should be softened so as not to imply the quantitative precision that apparently the words do now.

I'd suggest that the Board might get better comments if in the Exposure Drafts it gave some suggestion of where it was on cost-benefit. For example, I have tried in vain to determine how capitalizing museum collections could possibly meet a cost-benefit test and have not come to any way it could. I could see how some information on current values and the amount of insurance might be useful but not the historic costs, and I guess, in commenting on that eventual Exposure Draft, it would help me to know how the Board thought it could get to that answer.

Mr. Leisenring: One of the things that I think we have to remember is that, at least from my perspective, I never viewed the cost-benefit notion as being one that is necessarily applied very effectively to "will I issue the standard or won't I." Some people imply that it's almost the whole standard as a go or no-go decision based on cost-benefit, but as a practical matter it's much more of an analysis that has to take place over a hundred decisions as to the type of standard, and the degree of precision and the types of measurement, all sorts of different things that are in a standard like a [Statement] 96 or an OPEB or a pensions. And not so much on a you-will-or-you-won't issue something.

Having said that, it does strike me that pursuing cost and benefit in some people's minds seems to be a matter of if we somehow were willing to look long enough we would be able to quantify those costs and the benefits. I think that might be true of costs, because we might agree on a definition of costs, but I'm almost positive we won't agree on a definition of benefit. For example, a good number of people said complexity equals cost, and we might intuitively agree to that. But I think maybe most people think some of the complexity in the stan-

dards is more than beneficial. If you take Statement 87 and what will ultimately come out in OPEB, for example, an awful lot of the complexity is there to mitigate the volatility in earnings that would otherwise occur. Someone must believe smoothing earnings is a benefit. I'm not sure that everyone in the room will agree to that, but there's absolutely no doubt that an awful lot of the complexities in a good many of our standards are amortization devices, corridors and the like, that we have put in because people perceive these as benefits in mitigating volatility. I think it might be very good, as Dennis said, to always have it in the back of your mind that you're at least notionally considering this. But I'm not really very confident we'll have a common framework for assessing benefit.

Participants in the April 24, 1990 Advisory Council meeting quoted above were, in the order in which they spoke:

Paul Kolton, Chairman, FASAC

Robert J. Swieringa, Member, FASB

Richard S. Robertson, Executive Vice President, Lincoln National Corporation

Gaylen N. Larson, Group Vice President, Finance, Household International

Jean-Paul Valles, Vice President—Finance, Pfizer, Inc.

Stephen A. Zeff, Herbert S. Autrey Professor of Accounting, Rice University

A. Clarence Sampson, Member, FASB

Edmund Coulson, Chief Accountant, Securities and Exchange Commission

Dennis D. Dammerman, Senior Vice President—Finance, General Electric Company

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U.S. COMPETITIVENESS AND ACCOUNTING STANDARDS

Editor's Note: On July 24, 1990, SEC Commissioner Philip Lochner participated in an Advisory Council discussion of an initiative by SEC Chairman Richard Breeden to reexamine U.S. accounting standards in light of the effect they might have in hampering the international competitiveness of U.S. companies and securities markets. Following are Mr. Lochner's opening remarks and some of the comments of members of the Advisory Council and others who attended the meeting.

Persons quoted in the following excerpts are identified by full name and affiliation (at the date of the meeting) on page 58.

Mr. Kolton: As the world has become increasingly competitive, some argue that the ability of U.S. companies to thrive internationally is hamstrung by accounting standards that put U.S. organizations at a competitive disadvantage. If this is so, then some people hold that accounting standards should be tailored to provide a competitive edge or at least constructed so as not to cause a competitive disadvantage. This idea—that accounting standards should be instruments designed to effect economic events—is not new. The Board has heard it often—and it collides with the Board's mission statement, which says outright that the urgent need is for objectivity to ensure, as far as possible, the neutrality of information resulting from standards.

The growing importance of today's topic is underscored by the several special guests who are with us. Philip Lochner is the SEC commissioner Chairman Richard Breeden has asked to explore whether there are any actions the Commission should take to reduce the complexity and cost of U.S. accounting rules. David Malmquist, who also has been following this issue closely, is the SEC's associate chief economist and is at the table with us. Art Wyatt, a former Board and Council member, is increasingly involved in international accounting matters in his role as chairman of the IASC.

Mr. Lochner: To a large extent, I see this discussion as a continuation of the one you had on April 24th, which was a discussion of the cost-benefit issue. Obviously there are many factors which affect competition, including the costs of ac-

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This chapter comprises excerpts from a discussion at a meeting of the Financial Accounting Standards Advisory Council, July 24, 1990.

counting principles and practices. I don't think we should overemphasize the accounting costs. I don't believe that in any way those costs are determinative of the outcome of competition. Nonetheless, I think it's important to look at accounting costs as *an* element because any regulatory structure does impose a cost. That comment applies equally well to what the SEC does or the Department of Labor or any other regulatory body, whether it's government or private.

I also want to say at the outset that there are factors which have been extremely important in the development of the U.S. securities markets, and that the principles of full and adequate disclosure are among them. The cost-benefit discussion has to be—I believe—kept in the context of that principle of full disclosure. No one wants to impair the effectiveness of our basic disclosure principles. I do think, though, that within that context costs and benefits need to be examined closely. This principle is obviously found within the FASB's own set of principles as the discussion back in April suggests.

I think it's also worth stating that the cost-benefit analysis is an important principle, it's not by any means a minor principle, and that the Commission—and I speak at least for myself and the chairman and we have discussed these matters with the other commissioners—the Commission hasn't taken any official position on these matters, but I think there is a general consensus that a cost-benefit analysis is a very important part of what the FASB does.

How does this relate to international competitiveness? I think we all recognize that U.S. businesses no longer compete solely within the United States. That in order to—in effect—give a full cost-benefit analysis we need a broad and comprehensive view of those costs and those benefits. Many costs and benefits are not directly observable. They're nevertheless, I think, often real and important, and they need to be part of our calculation. Calculating costs and benefits is not easy. No one, I believe, thinks that we can simply punch into our PCs and come up with a cost-benefit analysis of the adoption of any given accounting principle in practice.

One issue is: Are the full range of costs of setting a new standard adequately considered in a standards-setting process? These surely include the costs of adoption—that is, the cost which issuers incur in understanding and implementing any change, the ongoing costs of monitoring, the costs, indeed, of altered behavior with respect to a new standard. If costs are imposed on U.S. companies when accounting standards cause their financial condition to be viewed adversely compared to foreign companies, should U.S. standards consider this factor in determining which among the range of acceptable accounting standards should be adopted? I believe that is a factor that should be considered.

Mr. Lochner: Exactly. That's entirely possible.

Mr. Meinert: And that should be considered.

Mr. Lochner: Oh yes, I think so. And again, I'm not trying to suggest the weight a given cost or a given benefit ought to be given. What I am trying to argue for is a broad understanding of costs and benefits and a view that costs and benefits ought to be very important to the FASB.

Mr. Meinert: Unfortunately, we have obvious costs and hidden benefits.

Mr. Dammerman: Just one comment. I think one thing that concerns me: The Commission is largely talking about—when they're talking about the issue of U.S. competitiveness—if we are talking about cost-benefit that's the emphasis. I think that we're going to talk right by each other. I mean we both can be saying the same thing. The business leaders of America can be saying the accounting standards are making us noncompetitive. The Commission can be saying we recognize that we're moving in the same direction and they're driving to keep U.S. business competitive, but if we talk in terms of cost-benefit (if that's the emphasis on the Commission's side), then those two groups of people, at least, are going to be talking by each other, not to each other. The reason being, I believe, that the chief executive officers of America, right or wrong, get their report card at least once a quarter, and it's generally called earnings per share, and that report card reflects accounting. It doesn't always reflect reality necessarily nor does it always reflect the economics of one accounting standard versus another or the cost of one accounting standard versus another.

The initial concern about OPEB was that it would make U.S. companies noncompetitive because they had to recognize in earnings per share what was already a reality. We know that. It's reality. And it doesn't make Chrysler any more uncompetitive then it was before. It doesn't have any impact on the economics—we know that—unless we react to it. But I guess the only point I'm trying to make is if the emphasis of the Commission is on considering cost-benefit trade-offs in the traditional sense, as I think the FASB has always been charged to do, then I don't think that's what American industry is talking about when we are talking about U.S. competitiveness.

The next example they'll give you is: you go to the UK and what happens to goodwill. We all know economically it doesn't make any difference. It's how you bookkeep it, and that of course doesn't change the economics. So those are the kinds of things that American industry is talking about and the CEOs of American

markets. And frequently it is asserted by a foreign entity that would like to raise capital in the United States that the costs of doing so, from the regulatory perspective, are too high and they can get their money without incurring those costs if they go to Frankfurt or London or Zurich. That's not an issue having to do with accounting standards—that has to do with the way our overall financial reporting and regulatory environment has grown.

Also, somebody put forth the example of the U.K. policy on writing off goodwill as giving U.K. companies an advantage and that's been asserted in the press. It's not a new matter. I'm concerned about any efforts of the FASB, or really any national standards setter, to try to adopt a standard that would provide a competitive advantage because I think it would be very short lived. Other countries would react and then we would be going down a road where accounting standards wouldn't have any common threads, just who can arrive first and hope to gain a temporary advantage until the others figure out what is going on.

And I think in the International Accounting Standards Committee our objective is really aimed at creating a more level playing field over a period of time. Our focus is the same as that of the FASB. It's on investors and creditors and it accepts the accrual accounting basis. We have not gone anywhere near the level of detail that is found in U.S. standards, and therefore cost in terms of compliance with international standards is less than would be the case with U.S. domestic standards. On the other hand, the lack of detail may also permit companies to report they're following the standards when, in fact, they're getting quite a different answer from a competitor in another country and, therefore, I think there is a balance that has to be achieved between broad general standards and a level of detail.

In IASC we have a particular problem because the laws and customs of the countries are so different. For example—not to pick on anybody—but the Germans clearly don't want to be dominated by the Anglo-Saxon view. They simply won't accept it; it has to bubble up in some other fashion so that it isn't identified as the FASB view or the Anglo-Saxon view. On the other hand, what is going on in Europe is creating a much higher degree of cooperation amongst the countries on a lot of matters, of which accounting is only one.

So, when you combine the European Commission's efforts, when you combine that with the GAAT talks, where they are now getting involved in services, and presumably that would mean accounting services as well, desires on the part of one country to use accounting to improve its competitiveness with the other countries I think are counter to the way the world is evolving. That has led me to

a certain amount of distress when I read the news reports on some of the statements of some of the commissioners, which I think were clarified in a couple of meetings that I've attended.

Mr. Kolton: Thank you, Art. Let me raise a question of Bob Rothermel because I saw a study recently reported—a Peat Marwick study of 158 U.S. financial statements that had been converted to German GAAP—and the results of that study indicated that the profits of those companies once the conversion had taken place, dropped to less than half of what they had been under U.S. standards. Now that number, the gross number, should be qualified by a number of issues that were peculiar to this study and to a number of important differences between German regulations and U.S. regulations. But it does suggest, at least on the face of it, the German requirements are tighter than those in the U.S., and that raises the question as to whether foreign companies, in this case German firms, wouldn't make the same argument that they are unnecessarily handicapped, in this case in the capital markets, by their own standards. Is that the sort of argument that we're apt to hear?

Mr. Rothermel: I'm not familiar with that study but conceptually, in terms of my experience with the Germans, many of their provisions that they make in their accounts are currently deductible and driven from the tax side, and to me in our discussions here we haven't mentioned to a great extent this morning the tax attributes of different accounting. I think the tax codes are a major factor.

Mr. Dammerman: Paul, on that study, if you went over to those 158 German companies you'd also find in the lower right hand desk drawer of the chief financial officer a set of statements that he uses for his important shareholders which is prepared on a basis that is reasonably consistent with U.S. GAAP. And that's what they give to the Deutschebank and their other major shareholders. They don't have shareholdings that are nearly as dispersed as we do, and that's what they hand them and they say here's the real answer.

Mr. Kolton: That really raises the neutrality question again. We've heard several people comment on the neutrality issue. Let me ask Joe Tharp. Is a neutral financial reporting requirement, one that doesn't shade or give an advantage or a disadvantage, is that an important factor in the credibility of financial reports? Is competition a sufficiently important factor or deterrent so that the neutrality issue should be revisited?

Mr. Tharp: I think that it is important to have neutral financial systems. It seems to me that part of what we are talking about here is in addition to accounting principles and their impact—and I think Bob alluded to this. You really have to consider several other major areas that impact competitiveness such as legal and regulatory, the taxation system that Bob mentioned, cultural differences, saving rates in particular countries, or levels of education and—I think the most important—shareholder expectations. Because clearly the shareholder expectation for a U.S. company is quite different, in my experience, from the shareholder expectation of a Japanese company, and therefore the cost of capital comes into play as a very important element of what we are talking about and therefore the need for a cost of capital return to meet shareholder expectations.

And in my own particular situation, in trying to meet a shareholder expectation and a proper return to increase shareholder wealth, it's impossible for me or my company to take the cost of funds from the U.S. market or a European market and put that in a Japanese market to build a retail banking system and to make local loans at 6 percent when the expectation of our earnings is some 18 percent. Which leads me in a roundabout way to something that I've always believed in, and that is cash is a businessman or woman's best friend. As we move through and think about harmonization and all of these things that we're talking about, it would occur to me that if we could move to where we could get very appropriate and consistent reporting on cash flows, cash outflows, the cost of capital—whether it be in Germany, whether it be in Japan, or whether it be in the U.S. or Canada—we ought to be able to begin to understand some of the differences that we are talking about, combined with some appropriate disclosure as to the future cash flow requirements in and out as well as the risk associated with cash flow and finances.

Mr. Kolton: Thank you, Joe. I want to pursue this issue of the compatibility or lack of compatibility of neutrality with competitive advantage because it seems to me it keeps rising in a number of ways. Simply put, Chuck Bowsher, can neutrality continue to be a guiding principle in the standards-setting process?

Mr. Bowsher: I think it should. And I'm getting more and more conservative here as I deal with more and more financial disasters. And so I would urge the SEC to consider some of the other issues here—in our financial institutions and our banks and everything like that. We're going to be issuing a report on the banking area. It's going to call for a relook at the financial standards in that area because right now I think we're issuing financial statements that don't tell the real story.

think looked at from other international aspects as being sort of dominating, and maybe even domineering in any discussions, it's difficult to see why it shouldn't be in that position.

I think it has set the standards which other people should be trying to emulate, with some notable exceptions in terms of the way people should harmonize. I suppose I have a feeling that you should not lower your standards just to come to international harmonization. I think the debate should continue. I think that you should be encouraged to have many of your people at least making contact with the other standards-setting groups, to participate, as indeed you are, in the international accounting forum. But I don't think you should necessarily be lowering your own standards. Perhaps adapting them, perhaps applying more specific rules where you can, if that is possible, but I would not be suggesting in any shape or form that you should not be going ahead with the things that are important in this market.

Participants in the July 24, 1990 Advisory Council meeting quoted above were, in the order in which they spoke:

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Charles A. Bowsher, Comptroller General of the United States

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