

The FASB and the Capital Markets

By John M. “Neel” Foster, FASB Member

This article addresses three related issues that have been prevalent throughout my ten-year term at the FASB and will likely be in the future:



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- The importance of neutral financial reporting to the efficient functioning of capital markets;
- The role of the FASB in achieving high-quality, neutral financial reporting; and
- The importance of preserving the FASB’s independence to achieving neutral accounting standards.

Capital markets allocate economic resources in this country in an extremely efficient manner. But

they can continue to do so only if participants in those markets have available to them credible, reliable and neutral financial information that faithfully portrays the economic effects of transactions.

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Uncertainty Influences the Cost of Capital

Numerous academic studies have concluded that more information in the marketplace lowers the cost of capital. Upon reflection, although it is nice to have empirical support, academic studies are not really necessary to reach this conclusion—it is intuitive. More information always equates to less uncertainty, and it is clear that people pay more for certainty. Less uncertainty results in less risk and a consequent lower premium being demanded. In the context of financial information, the end result is that better disclosure results in a lower cost of capital.

For example, let us say an investor has \$10,000 that he is required to invest and has a choice between two investment

alternatives. That investor has some information about one of the alternatives, but no information about the other. Having no choice but to invest the \$10,000, I cannot imagine circumstances that would cause the investor to choose the alternative about which he knew nothing unless it was apparent from the available information about the other investment alternative that it was a certainty it was a loser.

Another example where uncertainty results in a higher cost of capital can be seen in the marketplace everyday—junk bonds yield significantly more than treasury bills. Obviously, the reason junk bonds have a higher yield is that there is more uncertainty about whether the principal will be returned.

Some people who prepare financial statements apparently do not buy into the paradigm that uncertainty results in a higher cost of capital. This is apparent from the resistance we get at the FASB almost every time we propose to issue a new standard directed toward improving the understanding of a company’s financial position and results of operations. Consider disclosures about derivatives, for example. I voted for Statement 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, even though its disclosure requirements were limited only to the effects of the derivatives themselves, largely because I thought that, given the bad connotation that any use of derivatives had at that time, issuers of financial statements would want to tell the whole story. I thought concerns about how users of financial statements would react to an entity’s use of derivatives, especially if the derivative positions had resulted in losses for the period, would compel people to provide an in-depth explanation of their risk-management policies and how the derivatives held or used related to or offset the underlying exposures that they were trying to hedge. I was wrong. Except for financial institutions, which do a pretty good job of explaining their risks, most entities have simply complied with the minimum disclosure requirements that are now embodied in Statement 133, *Accounting for Derivative Instruments and Hedging Activities*. Companies generally do not relate their derivative transactions to the risks that they are hedging or explain how gains and losses on the derivatives are offset by losses and gains on other transactions. The result is that investors and potential investors still do not understand many *companies’* risk-management activities.

Importance of Investor Trust in Financial Statements

Another indication of the importance of credible financial information can be found in the recent call for a single set of international accounting standards that could be used by everyone

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to raise capital in any country without reconciliation to U.S. generally accepted accounting principles (GAAP). Much of the clamor has occurred outside the U.S., and the reason this issue is so important to offshore companies is that they want to raise capital in the U.S., but some do not want to have to file under GAAP and other SEC disclosure requirements.

Only three major exchanges in the world do not already accept International Financial Reporting Standards—those in the U.S., Canada and Japan. So, why is it so important that they be accepted in the U.S.? It's like Willie Sutton said when he was asked why he robbed banks: "Because that's where the money is." And the reason the money is here is no accident. It's here because investors, who supply the money, trust the U.S. markets.

Clearly that trust results from investors' belief that financial statements prepared under GAAP are reliable, relevant, consistent and comparable. That, in turn, is the result of a body of high-quality financial reporting standards established by the FASB and its predecessors. Despite the recent accounting scandals, generally, the high level and quality of financial reporting and disclosure, which enable investors to confidently compare investment alternatives, have attracted the suppliers of capital, making our markets the premier markets of the world—markets that coincidentally yield the lowest cost of capital.

Role of the FASB

The 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 statements. In fulfilling that role, we help reduce uncertainty and thereby lower the cost of capital by maintaining and developing standards that provide decision-makers—investors—with thorough, neutral and credible information to enable economic resources to be allocated as efficiently as possible.

There are two inevitable characteristics of every issue we address that destine the FASB to be an unpopular institution. First, the issue, and almost any proposed answer, will be controversial. Easy questions do not need accounting standards. Consequently, we only deal with difficult questions—questions that engender strongly held views and much disagreement.

The second characteristic is that FASB pronouncements almost always have consequences that some consider undesirable. To management, an accounting standard represents a loss of control over information—that is, the loss of the ability to decide whether, when or how to present information. It is well known that people don't like change. They especially don't like changes that are perceived to adversely affect them, and most new accounting standards restrict the ability to manage earnings or display, which is perceived as a particularly adverse effect when bonuses and stock options are at stake.

The Board understands that managers will sometimes alter their behavior in response to a new accounting pronouncement. This is a natural result of reporting information. People manage what they measure or get measured by. But, if financial information had no consequence, if it did not change the way markets and users of financial statements evaluate performance, it would be of little benefit.

To make the best economic decisions, users of financial statements must have statements that are both useful and credible. If financial statements are to be useful, they must report *all* economic activity, not selected activity, as faithfully as possible. If they are to be credible, they must neither omit information nor color the message to favor one party over another or a specific transaction structure.

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Importance of Neutrality

The need for useful and credible financial information on which to base decisions is the reason that the FASB strives to establish neutral accounting standards that provide a picture of a company's financial position and its results of operations in a way that is unbiased and as complete and faithful as possible. It also is the reason we believe that good financial reporting requires accounting for similar transactions and circumstances similarly and for different transactions and circumstances differently.

Some suggest that the FASB should consider the economic or social impacts of accounting standards. The FASB should not act, they maintain, if a new accounting standard would have undesirable consequences. That argument has been made frequently over the history of the FASB. We heard this argument the first time we addressed the accounting for stock-based compensation, and we are hearing it again in this go round. But, it has also been raised in projects on accounting for pension liabilities, postretirement benefits, derivatives and business combinations. It has been asserted that changing the accounting for these transactions would be the end of Western Civilization. Obviously that is a bit of an exaggeration, but it does generally capture the flavor of the objections.

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There is a common thread in all of these assertions. Those who make them may pursue desirable goals, like providing retiree healthcare to their employees or reducing economic risks through hedging. But they hope to achieve the goal without clearly explaining its financial impact to those who use financial statements. On the surface this may seem desirable, but in the long run it can be very harmful. The costs and benefits of transactions exist whether or not they are recognized and reported in financial statements. Concealing the financial impact of certain transactions from those who use financial statements may benefit a company in the short run. However, over the longer term it will ultimately increase that company's cost of capital to a higher level than it would have been without the concealment. This is obvious if one follows the stock price consequences of some of the recently reported scandals. Moreover, on a macro basis, it can only lead to inefficient economic decisions and misallocation of resources.

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The adverse consequences of abandoning neutrality by concealing the true impact of certain transactions can, perhaps, be best illustrated by the collapse of the thrift industry. During the 1970s and 1980s many argued that GAAP would force regulators to close institutions and that institutions using GAAP would not be able to compete in development and commercial lending. Preserving the industry became an overriding objective. Consequently, regulatory accounting principles were altered to obscure problems in troubled institutions. I certainly would not suggest that the lack of transparency resulting from the accounting caused the downfall of the thrift industry, but it did enable the people responsible to ignore the problem and pretend it did not exist, thereby delaying action that could have contained the problem when it was relatively small.

The same sort of activity has recently occurred in Japan where the government sanctioned banks' hiding loan and securities losses with the same inevitable result. Companies can only hide behind the accounting for so long—eventually the truth will be revealed.

Most people would condemn slanting or concealing information in the pursuit of national goals. They also would be appalled at the suggestion that selected SAT scores be altered to improve a certain student's *chances* of admission to a particular university or, worse yet, make one team's goal in an athletic contest smaller than the other team's goal. I believe those same people would be equally opposed if asked directly whether accounting standards should be slanted to favor one company's ability to raise capital over another's. Yet, the FASB is continually lobbied to do exactly that.

FASB's Role in Public Debates

We also must recognize that, as a private entity, the FASB has neither the authority nor the qualifications to weigh various, and often conflicting, national priorities or goals. Nor do we seek that authority. Consequently, we must discount those arguments that maintain a proposed standard is bad public policy. There may be others who think it's good policy. Our charge is not to decide who is right in these arguments. Rather, our mission—and the only public policy goal with which we can be concerned—is to improve, through accounting standards, the usefulness of financial statements so that public and private decision-makers have the information to make better, more informed decisions.

We often hear assertions that our standards will have adverse economic effects, such as certain industries will lose their competitiveness resulting in lost jobs, or people won't enter into as many derivative transactions or companies will discontinue their stock option plans. These assertions are generally prognostications that cannot be supported by actual data. But even if they turn out to be true, if those effects resulted from the market (that is, the decision-makers) having more and better information, which in turn resulted in a redirection of capital, isn't that the right consequence from a public policy standpoint? A “no” answer to this question denies that free markets and market forces result in the most efficient allocation of resources and that efficient allocation of resources should be the foremost public policy goal. Free markets cannot function effectively if they are deprived of reliable and neutral information.

Supporting the FASB's Role

I recognize that it is human nature to try to influence the rules—any rules—to an individual's or organization's advantage, and even though we try to resist those efforts, we expect people to do so. However, if the institution setting the rules is to survive, people must be willing to abide by the rules. While this is not the first time it has happened, there is currently an interest group lobbying Congress to overrule or prevent the issuance of any standard that would require companies to recognize the cost of stock options in their financial statements. While this group, for the most part, claims to support independent, private-sector

standard setting and the role of the FASB, it is clear from their actions that they don't. Rather, they want to be able to say that they support private-sector standard setting and at the same time be able to control it. They can't have it both ways. They can't say they support having standards set in the private-sector and, concurrently, because they don't like a particular standard, appeal to a higher public authority to have it overruled. Again, one either supports the process or doesn't.

Arthur Levitt, former Chairman of the SEC, once stated, "The true test of a democratic institution is whether it is respected even by those who disagree with its decisions. If we don't abide by FASB's decisions when they go against our interests, then we will seriously undermine, and ultimately destroy, the institution."

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I agree with Chairman Levitt's observation. If a group of constituents that is dissatisfied with a proposal or a standard issued by the FASB has the ability to successfully appeal to Congress to overrule that standard, the authority and the viability of the FASB will soon vanish. If the FASB were no longer viable, one of two things probably would happen. One possibility is that the FASB would be replaced by a new private-sector standard setter, which likely would have a structure extremely similar to that of the FASB—perhaps one even more insulated from outside pressure.

The other possibility is that the SEC or some other governmental agency would take over accounting standard setting. If that happened, I don't believe anyone would be happy with that result for very long. Governments come and go, and as administrations change, the political color and policies change with them. I don't believe anyone would want accounting standards to continually tack with every change in the political winds, or to be determined by social policy or the special interests that *others* have—think about the tax code. Some of the answers under that regime might be appealing, but, I venture to say, there would be some standards that some would find extremely unfair.

Conclusion

I conclude by summarizing the three issues discussed. First, the principal reason the U.S. has the preeminent financial markets in the world is due to the quality, timeliness and credibility of the

financial information and disclosures required of public companies. That, in turn, is the result of the support and resources provided to private-sector standard setting in this country over the last 70 years.

Second, those that would have accounting standards influence the allocation of capital to achieve a perceived public policy goal or further their own self-interests are, in reality, opposed to the free and efficient market system that is universally acknowledged to be the driving force of the U.S. economy.

Third, the FASB will not survive if every time a special interest group doesn't like a standard, it appeals to Congress or the SEC to overrule it. If it is desirable that accounting standards be set in the private sector, universal support of the process—always, not just when the answer is appealing—is imperative.

On June 30, FASB Board member John M. "Neel" Foster concludes his second and final term with the Board.

Neel joined the FASB in July of 1993 after having served as Vice President and Treasurer of Compaq Computer Corporation. During his ten-year career with the FASB, Neel helped establish a long list of standards, including those on accounting for stock-based compensation (Statement 123) and derivatives (FAS 133).