THE FASB'S COST-BENEFIT ANALYSIS

FEI-CFRI Conference

Presented by FASB Member Marc Siegel

Good morning. I want to thank the members of the CFRI committee—and my fellow panelists--for allowing me a few minutes to directly address an issue that's been of concern to you and to other FASB stakeholders: namely, how we think about and decide whether the benefits of new standards justify the costs of change. I need to remind you that my views are my own and don't represent the views of the Board as a whole.

People think of different things when they hear the words costs and benefits. I will attempt to describe what we do at the FASB and what we do not do. Right up front, I want to be clear that there is a difference between analyzing costs and benefits and undertaking a full analysis of economic consequences. To me, economic consequences are what results from neutral, relevant financial information. If the market is provided with neutral, relevant financial information, the economy will, as a whole benefit. The benefit will take the form of more efficient capital allocation overall. I'll describe this further in a minute.

About two weeks ago, Dr. Stephen Zeff visited the FASB and shared his perspectives on the evolution of accounting standards. Dr. Zeff, as many of you know, is one of the foremost accounting historians in the U.S. I say he's "foremost" in his field because he knows his stuff and because he makes the topic of accounting history interesting—not an easy task.

Dr. Zeff's prolific writings include an article titled "The Rise of 'Economic Consequences.'" The article talks about the growing expectation among government leaders that accounting standard setters take into consideration potentially adverse social and economic consequences of their standards.

One might assume that Dr. Zeff could have been writing this in 2014 about the dilemma facing the FASB and its current leases project. Any guesses as to when this article was actually published? It was 1978. Dr. Zeff also noted the following:

> Economic consequences bids fair to be the most challenging accounting issue of the 1970s.

Clearly, thirty-six years later, the overall topic of cost-benefit is *still* one of the most challenging issues we face. And I'd like to address it today by explaining how we think about the issue, the process we use for determining whether the benefits of a standard justifies its costs, and how that process informs—and has informed--our decisions in key projects.

In that process, first, we think about whether the benefits of a standard—which are improvements in the relevance and neutrality of reported financial information – justifies the costs it imposes on financial statement preparers to implement the new standard and on users to consider and respond to the new information. Second, if negative economic consequences of a new standard are asserted, we pause. We then assess whether those are intended consequences of neutral financial information

– a leveling of the accounting playing field so to speak. Alternatively, they could be the result of unintentionally biased financial information. If it's the latter, the Board will look at the issue again..

And when we're thinking about the benefits of a standard, we think in terms of the information it imparts to investors and other financial statement users. Specifically, is the information produced by that standard relevant and important to the user? Does the information it gives the investor justify the costs of providing it?

We assess the potential benefits by gathering evidence about whether changes to accounting and financial reporting would

- accurately and neutrally reflect the underlying economic transactions and events
- improve or diminish comparability of the reported financial information domestically and internationally, and
- affect the effort or cost of using the information.

The Board's consideration of costs and benefits happens continuously throughout a project's life cycle and not just once, before an Exposure Draft or final ASU is released. In fact, we look at these things before a project is even added to our agenda. During this "pre-agenda" research phase, we ask ourselves whether there's really a problem that can be addressed through standard setting. If, after careful consideration, we conclude that there is, we work to clearly articulate the issue and evaluate the relative cost-effectiveness of possible solutions.

A good example of this is our joint project on Leases. An SEC-staff study undertaken in the aftermath of the Enron crisis identified operating leases as one significant source of off-balance sheet accounting that should be reconsidered. During our pre-agenda research, many investors told us that they routinely adjusted the financial statements of companies to add the liabilities related to operating leases. They noted that the current accounting for operating leases does not faithfully represent the economic leverage at companies with significant lease obligations. The SEC and investor feedback identified a problem – that off-balance sheet treatment of operating leases doesn't provide relevant information about economic obligations and creates an unlevel playing field between companies that lease and those that do not. It suggests that recording these amounts on the balance sheet would make it more efficient for investors and lenders, making the information more accurate and transparent than the "back of the envelope" estimates they already were making.

Based on these and other considerations, the FASB and IASB added the leases project to its joint agenda.

After deciding to work on the identified problem, the staff endeavors to present alternatives to find the most cost-effective way of meeting the information needs of investors and other users. As such, through outreach, field visits, field tests or other means, we gather evidence about the effects—or costs--of potential changes, especially those related to the process of preparing and distributing the information. This includes

- the effort required to collect, analyze, and process the information,
- the effort and cost involved in auditing the information, and

- the effort involved in implementing the change, including costs to understand the new rules, systems changes, potential competitive harm to preparers, and so forth.

As part of this process, we seek information from many companies, large and small, public and private, about the additional costs that they would incur were a new standard to be put in place. We ask them specific questions about the number of new employees or outside consultants that would be required to implement the new standard—and the additional time that would be needed to meet the requirements. We also ask about the need to develop new or modified accounting systems. While we don't attempt to develop models to project the new costs that all preparers would incur, we believe that analyzing projected cost increases for a cross section of different companies leads to an equally useful result. Through this analysis, the FASB seeks to understand which provisions of a proposed standard would be the most difficult or costly to apply. It then compares those costly provisions to what it understands about the relevance or importance of the information to users. The Board considers changing a proposal when the analysis reveals an imbalance between the cost and relevance of the information.

For example, and I hope you don't mind me switching projects here - before issuing our revenue recognition standard this year, we wanted to ensure that the proposed disclosures would provide users the information they needed without putting undue cost burdens on the system. To make sure it achieved this goal, the FASB and IASB brought together financial statement preparers and users in a room. We gave them a list of the disclosures we proposed in the Exposure Draft. In essence, we asked the preparers to rank those disclosures from “most costly” to “least costly.” We generally asked the users to rank the disclosures from “most relevant” to “least relevant.” This exercise helped us reconcile the needs of users with cost considerations of preparers so that the final standard would strike the right balance.

As you can imagine, we learn a lot from this kind of cost-benefit analysis. When it appears that the cost of proposed provisions would not justify the benefits to the user, we look for more cost-efficient ways to provide information. This, in fact, is one of the primary reasons why we’ve diverged with the IASB on some key areas of joint projects.

Again, coming back to the leases project. Both the FASB and IASB proposals address a significant perceived weakness – that being off-balance sheet obligations – We address this weakness in similar ways and both of our current conclusions produce similar liability recognition and earnings for companies in a steady state.—Companies provided information, however, that convinced us that the single model approach proposed in the 2010 joint Exposure Draft would be expensive and complicated to implement in the U.S. After considering that input, the FASB developed another, less costly alternative.

The FASB’s cost-benefit analysis also has informed our most recent decisions on the classification and measurement of financial instruments.

In 2013, the FASB proposed a two-step test to classify and measure financial assets– similar to IFRS 9, as amended by the IASB’s limited amendments ED. The first test was the cash flow characteristics test, and the second was the business model test.

Outreach and comments from stakeholders indicated that there could be significant costs in adopting these new classification criteria. Additionally, some stakeholders observed that the classifications for many debt instruments would likely not significantly change. The FASB ultimately decided to not pursue the cash flow characteristics test because U.S. stakeholders convinced us the test would swap the known complexity of current GAAP guidance with the unknown complexity of this new test. In other words, the benefits of the insignificant changes in outcomes would not justify the costs.

As part of our disclosure framework project, we're also in the process of conducting extensive cost-benefit analysis. The goal of the project is to develop more effective—and cost-effective—disclosure requirements. Currently, we're looking at disclosures for income taxes, defined benefit plans, fair value measurement, and inventory as well as interim reporting.

Since embarking on this initiative in 2009, we've formed a disclosure resource group, hosted two public forums on the topic, and conducted outreach with hundreds of users and practitioners. The insights we've gleaned from these meetings are helping us find the most cost-effective means of making disclosures more relevant for users. For those of you interested in this topic, I'd add that our next forum takes place at Pace University on December 1st and is hosted by our former chair, Leslie Seidman. Like our previous two forums, we'll use this opportunity to engage with stakeholders on the current state of financial disclosures and get their input on our current efforts to improve their effectiveness.

While we're on the topic of our analysis of costs, I should mention that our disclosure framework project is just one of the ways the FASB is focused on reducing overall costs in financial reporting system. The costs of financial reporting, while paid for by companies, are borne by the owners in those companies in the form of reduced returns. Reducing the cost of financial reporting without significantly reducing the relevance of financial reports benefits investors. So, we have been reviewing existing standards to look for costly provisions that result in information of limited utility for investors.

This simplification initiative involves a series of narrowly-scoped projects that include presentation of debt issuance costs, measurement date of defined benefit pension plan assets, balance sheet classification of debt, accounting for income taxes and the measurement of inventory. This is an ongoing initiative that will continue to give us opportunities to benefit all stakeholders by reducing unnecessary costs.

Potential Consequences of New Standards

Now, let me switch gears briefly and discuss not the **cost** of standards, but the potential **consequences** of new standards. When we talk about cost analysis, we sometimes are asked by stakeholders if our analysis takes into account the economic impact of proposed accounting standards. In fact, the FASB is not indifferent to the potential consequences of new standards to businesses and industries—but such consideration is separate and distinct from the cost-benefit analysis.

I think it's important to remember that the purpose of accounting standards is to foster clear and useful financial reporting that reflects economic activity faithfully and neutrally. Said another way, accounting standards are intended to reflect—not to drive—economic activity and behavior.

Our aim is to create a neutral playing field that enables investors, lenders, and other users of financial statements to make their own independent judgments about where to invest, based on the best possible information available. We strongly believe that accounting standards are intended to report economic activity as faithfully as possible without bias.

That said, we recognize that relevant, neutral financial reporting does have economic consequences—if it didn't, there would be no point in making the change. Those consequences can be both positive and adverse.

Positive consequences would include fostering economic growth by promoting transparency, which in turn leads to more efficient capital allocation, greater market liquidity, a lower cost of capital, and an overall better allocation of capital. But we recognize that the benefit of more efficient capital allocation for the economy as a whole doesn't mean that there will not be some businesses or industry sectors that are adversely impacted.

As investors receive better information about where to invest their money, they are able to make better informed choices. Therefore, replacing inaccurate information with accurate information could result in adverse consequences to some businesses or industry sectors.

For example, a new standard may require a company to reveal liabilities it previously had not been required to show in its financial statements. This new information could result in reduced capital flow to the company, or an increased cost of capital. It might also result in that business having difficulty attracting and retaining talented employees, or in the worst case scenario, result in its failure.

When adverse economic consequences are asserted, we must ask ourselves whether those consequences are the natural result of more relevant and neutral financial information, or the consequence of unintentional bias resulting from the proposed standard. In other words, is this happening because the standard *doesn't* work…or is it happening because the standard *does* work?

If our consideration reveals unintentional bias, the Board changes its decisions as necessary to restore and promote neutral reporting.

If, however, our analysis reveals that the proposed outcome is representationally neutral, as complete as possible, and presented in a way that lets users comprehend its meaning and significance—in other words, the standard works—then we believe it is the appropriate way for the FASB to think about economic impact.

Conclusion

To close, I recently found a FASB ViewPoints article by Jim Leisenring who wrote in 1999, and I quote:

> Unfortunately, it is once again fashionable to suggest that the FASB should abandon the notion that decision useful information must be neutral and should consider the economic consequences of its decisions.

Hopefully, I've described that our entire standard setting process is about obtaining information about costs and benefits. And when stakeholders assert that adverse economic consequences will result from our proposals, we pause in order to evaluate whether those consequences are because the proposal is *not* working, or is it because it *is* working and the proposal does faithfully present the economics.

When making cost-benefit decisions, the Board carefully considers whether a standard's benefits—the information it provides financial statement users—justifies its costs—to those who must implement them. While our primary responsibility is to provide investors and other users with the information they need, we always are seeking the most cost-effective ways to provide that information. That's why we're attacking it not just in agenda projects, but also through big picture initiatives designed to reduce cost in the system.

And finally, we believe that the benefits of providing a neutral picture that faithfully represents a company's financial position is the best contribution to a strong economy—even when it means revealing less-than-positive information about how certain industries or organizations are managing their resources.

As always, of course, you are key to helping us achieve these objectives. Your input is critical to helping us find the right balance. You can help by providing your views on our proposals and continually providing your feedback throughout our process.

And now, on to our FASB Update. I'm happy to take your questions at the end of our presentation.

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