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Setting Standards Scalably (Part 1)

The quality of financial reporting standards will suffer if the FASB and the IASB don't improve the scalability of the standards-setting process.

The U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have planned to make an unprecedented number of significant changes to U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) over the next 18 months. In future columns, I'll explain those changes and their implications as I've done in the past. But this month and next, my column will focus on the *process* by which the Boards set and change their standards.

My reason for focusing on the standards-setting process is straightforward. Reporting entities and their stakeholders are at imminent risk of being buried in an avalanche of poor-quality financial reporting standards. The source of that risk is the lack of *scalability* in the current standards-setting process. Read on to learn more about the risk and, next month, what can be done to eliminate it.

The Process

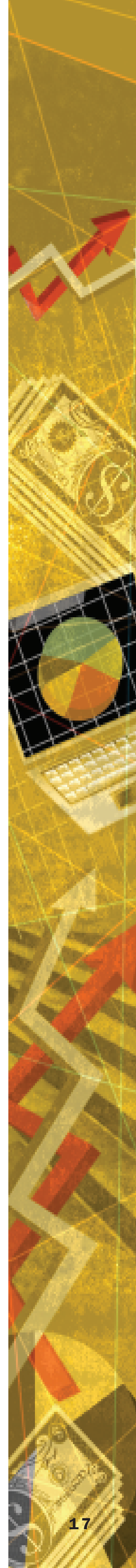
The FASB and the IASB follow essentially the same process for setting financial reporting standards. As stated on the FASB website, "The mission of the FASB is…accomplished through a comprehensive and independent process that encourages broad participation [and] objectively considers all stakeholder views…" (www.fasb.org/facts/index.shtml). The IASB website states that "[T]he IASB follows a thorough, open and transparent due process of which the publication of consultative documents…for public comment is an important component. The IASB engages closely with stakeholders around the world…" (www.ifrs.org/The+Organisation).

In both cases, any interested individual or organization can participate in the standards-setting process. Although interested parties don't get to vote on the final standards—that authority is vested only in Board members—their participation does influence the standards-setting decisions that the FASB and the IASB make. As such, both Boards acknowledge that the quality of the standards that result from the process depends significantly on the participation of financial-statement users, auditors, preparers, and other interested parties in the process.

Individuals and organizations who participate in the standards-setting process often benefit significantly from their participation. Benefits include opportunities for them to:

- Gain early awareness of coming changes, which particularly helps preparers and auditors manage the costs of compliance;
- Verify that proposed standards can be applied to real-world transactions, events, and situations; and
- Ensure that standards are useful with regard to meeting the information needs of financial-statement users.

At first glance, it may seem that participating in the standards-setting process is costless. The Boards don't charge participants for access to the process or for any information that they make available. But the reality is that participating in the standards-setting process takes time, a minimum level of technical expertise, and often money for travel and meetings with other participants—all of which are scarce resources. So from an economic perspective, participating in the standards-setting process is far from "free."



Those who do participate must bear very real costs in order to do so, and there are certainly limits to the costs that participants are willing and able to bear.

Scalability

The term *scalability* refers to certain attributes that a process may or may not exhibit. A process is scalable if its throughput can be increased by increasing the quantity of resources used in the process. Scalability also means that the marginal costs of executing the process vary proportionally with the marginal benefits obtained from the process. In both of these aspects, the quality of the process's outputs is assumed to remain constant.

Unfortunately, the process by which financial reporting standards are set in the United States and throughout the world doesn't exhibit either of these aspects of scalability. This has given rise to a significant risk that future standards will impose undue costs and risks on auditors and preparers while failing to provide decision-useful information to financial-statement users.

Costs Don't Scale

The risk of poor-quality standards comes primarily from the fact that the costs of participating in the standards-setting process don't scale. More specifically, the costs for interested parties to participate in the process don't scale *down*—they don't decrease proportionally as the size of the participating entity decreases. Smaller companies and individuals bear roughly the same absolute costs to participate in the process as larger companies do. But absolute costs that are immaterial to larger companies can easily overwhelm smaller companies.

To illustrate, let's say the FASB issues one exposure draft (ED) each month describing a proposed change to U.S. GAAP. In order to participate in the process by which the EDs would ultimately become final standards, an individual would need to read and analyze each ED. But the amount of time required to do so isn't proportional to the size of an entity that would be affected by the final standards. If it takes, say, six hours for an individual to read each ED and analyze its impact on the individual's employer, that would be a relatively trivial task for a company whose financial department employs dozens of professionals. But the task would be prohibitively burdensome on the "OFO" (*Only* Financial Officer) of most smaller companies. And because the larger company is more likely to employ individuals who have specialized financial reporting expertise, it might actually take less time for a large-company specialist to read and analyze an ED than it would for a small-company generalist.

The lack of scalability in the costs of participation has precluded—and continues to preclude—most smaller entities and individuals from participating in the standards-setting process. As a result, smaller companies and their stakeholders are profoundly underrepresented in the process. And because the smaller-company perspective is so underrepresented in the process, the outcomes of the process often fail to take into account the unique needs and capabilities of the standards setters' smaller-company constituents. In short, the unscalable economics of the current standards-setting process virtually ensure that the standards we end up with will be neither useful nor cost effective for the vast majority of reporting entities.

Throughput Can't Scale

The risk of poor-quality standards also arises from a second scalability factor. As noted above, there are limits to the amount of time, expertise, and money that interested parties of all sizes are willing and able to invest in participating in the standards-setting process. Such limits render the process unscalable past the point at which all available resources are utilized. Unfortunately, as any participant in the process will tell you, we're already past that point. Thus, attempting to increase the throughput of the standards-setting process is almost certain to result in poorer-quality standards.

Yet increasing the throughput of the standards-setting process is exactly what the FASB and the IASB have planned. It's truly unfortunate that the process isn't scalable when we very much need it to be. We need better and more globally consistent financial reporting standards to help prevent another global financial crisis. We need to do something about standards for smaller companies because of the importance of smaller companies in restoring our national and global economies to good health. And we need to do these things sooner rather than later. But without a scalable standards-setting process, we're destined to end up with a

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bigger mess than we have now.

Simply cutting back on the throughput wouldn't enable standards setters to attain urgent standards-setting goals, and it certainly wouldn't make the standards-setting process work better for smaller companies and their stakeholders. To avoid promulgating or perpetuating poor-quality standards, we need a process that's scalable—and the current one isn't. Fortunately, it's possible to redesign the process to do more with the resources that are available and to ensure high-quality standards in the bargain. Look for the solution in next month's column. **SF**

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