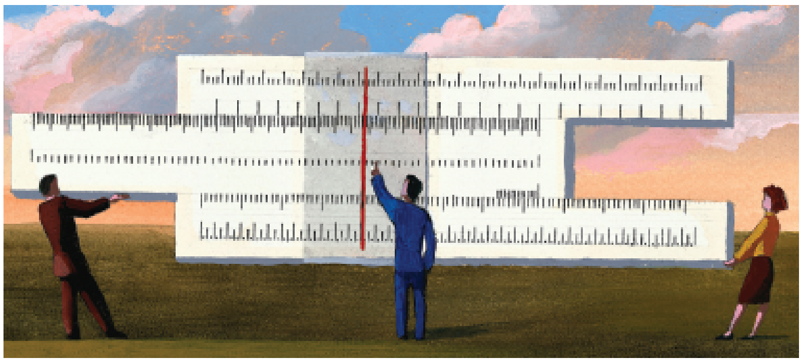
Bruce Pounder, CMA, CFM, Editor

Setting Standards Scalably (Part 2)

One simple change would significantly improve the scalability of the process by which financial reporting standards are set. The payoff? Higher-quality standards.



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In last month's column, I explained how the quality of forthcoming financial reporting standards will suffer unless the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) improve the *scalability* of their standards-setting process. This month, as promised, I'll explain how the scalability of the process can be improved and how greater scalability would translate into higher-quality standards.

To understand how the scalability of the Boards' standards-setting process can be improved as well as why it should be improved, it's necessary to understand how the process currently works. In particular, it's necessary to recognize the crucial role of the Boards' *stakeholders*—organizations and individuals who are directly affected by the standards that the Boards promulgate. The Boards' primary stakeholders include preparers, auditors, and users of financial statements that are prepared in accordance with the Boards' standards.

Typically, a standards setter such as the FASB or the IASB will labor in relative isolation for months, sometimes years, developing a new standard. Once the main development work has been done, the standards setter issues an exposure draft (ED) to formally propose the standard. The ED usually describes the proposed guidance by reference to existing guidance. Specifically, the standards setter takes the text of a current standard, marks it up with insertions and deletions, and includes the marked-up text in the ED. In most EDs, the standards setter also explains its rationale for proposing the new standard.

The purpose of issuing an ED isn't to conduct a vote, poll, or survey of stakeholder sentiment regarding the proposed standard. Rather, the issuance of an ED represents an opportunity for stakeholders to conduct a "final inspection" of the standard before the standards setter officially approves it.

A proposed standard is presumed "good to go" unless stakeholders can convincingly demonstrate that the standards setter got its facts wrong, overlooked relevant information, made unrealistic assumptions, and/or employed faulty reasoning. In the absence of such stakeholder input, the standard is virtually certain to be approved as proposed.

Unfortunately, it's prohibitively burdensome for most smaller organizations and individuals to provide meaningful input to the standards-setting process as it's executed today. Furthermore, as EDs are issued at an increasing pace, even large stakeholders are overwhelmed in their role as "inspectors." And so, as the throughput of the standards-setting process goes up, stakeholder attention to each standard goes from low to extremely low. Stakeholder input also tends to degenerate into reflexive opposition, unsupported assertions, and the same fragments of thoughts echoed over and over. Such input has little chance of satisfying the burden of proof that stakeholders bear for demonstrating that a proposed standard shouldn't be approved. Thus, the risk that arises from less stakeholder attention and less-effective stakeholder input is an increase in the likelihood of poor-quality standards being approved.

Making the standards-setting process more scalable would, by definition, help ensure that quality isn't sacrificed for quantity as the FASB and the IASB increase the throughput of the process to unprecedented levels. The key strategy for enhancing the process's scalability, and thus mitigating the risk of lower quality at higher levels of throughput, is to make it less burdensome for stakeholders to provide meaningful input to the process. And it's especially important to do so for smaller stakeholders whose perspectives have traditionally been underrepresented. Reducing the burden on all stakeholders would increase the number and diversity of stakeholders who are able to participate in the process and would also increase the quality of input that stakeholders are able to provide, even at higher levels of throughput.

There are several tactics that could be used in executing the key strategy of reducing the burden on stakeholders. But one simple change to the process would, by itself, go a long way toward reducing the burden.

Instead of presenting marked-up text to stakeholders for inspection, standards setters should present stakeholders with relevant operational models that are implied by proposed standards. The reason this change

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would enhance stakeholder participation in the standards-setting process is that currently, in order for a stakeholder to provide meaningful feedback on a proposed standard, the stakeholder must translate the ED's cryptic verbiage into an operational model. The effort to operationalize proposed standards is the most resource-intensive part of the process for stakeholders, who struggle to answer such questions as "How would this work in the real world?" and "What would I need to do differently?" Now, most stakeholders simply give up and disengage from the process.

Of course, there would need to be different operational models for different kinds of stakeholders: one for financial-statement preparers, a different one for auditors, and yet another for users. In every case, however, it would make more sense for the standards setter to develop each model once than to have stakeholders expend the same effort redundantly thousands of times. Additionally, there would be no risk that stakeholders would develop incorrect operational models as a result of interpreting proposed standards differently. And stakeholders would be able to provide feedback to standards setters far faster than they're able to provide it today.

There are many other process changes unrelated to scalability that would increase the quality of the standards that the FASB and the IASB issue. But just by shifting the burden of developing operational models from stakeholders to standards setters, standards setters could issue more and better standards because, even at higher levels of throughput, more stakeholders would be able to provide more and better feedback.

Given the large volume of standards that the Boards plan to issue over the next 18 months, maintaining a high level of quality is a must. Fortunately, we can have both quality and quantity with a simple change to the standards-setting process. **SF**

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