RECORD OF SOCIETY OF ACTUARIES
1987 VOL. 13 NO. 3

FASB DIRECTIONS

Speaker: VICTOR H. BROWN*

- A discussion of the structure within which decisions are made, the present philosophical position of the FASB and the implications of the new direction the FASB seems to have taken recently.

Expressions of individual views by members of the FASB and its staff are encouraged. The view expressed in this speech are those of Victor H. Brown. Official positions of the FASB on accounting matters are determined only after extensive due process and deliberation.

MR. VICTOR H. BROWN: The world of the FASB and the world of the actuary have been in fairly frequent contact in recent years. In 1985, the FASB issued Statements 87 and 88 dealing with pensions -- a subject near and dear to the hearts of many actuaries. We now have an exposure draft out on accounting for certain life insurance and annuity products. We are actively considering how to account for retiree health, life insurance and other benefits. We have another exposure draft outstanding dealing with income tax accounting. If adopted, it would have a special impact on the insurance industry. And we have been asked to examine how to handle risks and uncertainties in financial reports and when the notion of discounting should be applied in accounting.

These and other matters have made the actuary increasingly aware of the presence of the FASB. Matters dealt with by the FASB can be of interest to actuaries for at least two reasons. In some areas -- as in pensions and insurance accounting -- the actuarial and the accounting disciplines interact. In other cases, the FASB sets rules affecting the instruments, transactions, and institutions with which the actuary is closely associated. In these days of

* Mr. Brown, not a member of the Society, is a member of the Financial Accounting Standards Board in Stamford, Connecticut.

volatile interest rates, new and innovative financial products and transactions, and erosion of distinctions among various kinds of financial institutions, it is likely that the areas of mutual concern to the FASB and to the actuary will keep growing. Thus, I welcome the opportunity to broaden the dialogue between the FASB and the actuary. I'll explain briefly what the Board is all about and how we go about our business.

THE FASB

The FASB plays a unique role in our economy. It is a regulatory body, but it is not a government agency. It is an independent foundation financed by both contributions and by revenues from the sales of its publications. Contributions are primarily from corporations and public accounting firms. But a carefully drawn charter assures that the FASB is independent of its contributors.

By the same token, the FASB is independent of both the American Institute of CPAs and the Securities and Exchange Commission. This is so even though the clout of the FASB stems from the fact that both institutions accept FASB pronouncements as the prime authority for purposes of preparing financial statements in accordance with generally accepted accounting principles.

The Board is made up of seven full-time members who must sever all other business or professional connections and commitments before joining the Board. Three board members have come from public accounting practice. Two had been financial executives before joining the Board. One had a background in government finance and accounting, and one had been a professor of accounting.

Working directly with the Board is a technical staff numbering approximately 45 professionals drawn from public accounting, industry and academe. The staff conducts research, it analyzes oral and written comments, and it prepares recommendations for consideration by the Board.

THE MISSION OF THE BOARD

The mission of the FASB is "to establish and improve standards of financial accounting and reporting." Now financial reporting is not an end unto itself. The U.S. economy depends greatly on a smoothly functioning capital market. One essential lubricant for a capital market is full and fair disclosure of financial information for economic decision makers. Thus, the heart of the Board's mission is to improve the ability of financial reports to provide information that is useful for making decisions about allocating capital.

Some have suggested that the Board might go about setting standards by initially trying to agree on the objectives of, or a framework for, financial reporting. These objectives and this framework, if developed in enough detail, might serve as a basis for resolving problems -- if you will, a neat accounting model or formula by means of which questions could be resolved. Alternative solutions to particular issues could be tested against the framework or model. The solution most consistent with that framework would be the one selected.

Unfortunately, such a neat approach to resolving questions is not easy to implement. Some questions have been resolved on what has appeared to be essentially an ad hoc basis. Some of our standards and pronouncements have appeared logically inconsistent with one another. And some people have -- somewhat unkindly -- described the collection of current accounting standards as more of a mosaic than an orderly, articulated pattern.

Yet, it is perhaps not surprising that a formula approach to standard setting has not worked. Most of the questions that the Board is asked to address have no simple answers. Problems with ready solutions never reach the Board. Matters that we are asked to deal with are typically those about which reasonable and well-informed people differ. Among seven Board members, each with a different background and view of the world, there are differences of opinion, not only with respect to what the appropriate answer should be, but as to whether items should be added to our agenda in the first place.

Let me review the process the Board follows in addressing accounting problems. We can identify the agenda phase, the deliberative phase and the decision phase.

THE AGENDA DECISION

Some believe the FASB spends a good deal of time looking for problems to keep itself busy. Believe me, we don't need to. More problems are thrust on us than we can possibly handle. We receive many requests for action on various financial accounting and reporting topics. These requests come from all segments of a diverse constituency. The accounting profession is particularly sensitive to emerging trends in accounting practice. Consequently it is a frequent source of requests. The Securities and Exchange Commission is also in a unique position to identify changing accounting practices. Accordingly, it too is a source of requests for Board action. To a lesser extent, companies request FASB action on accounting questions. Academics do as well.

The FASB itself sometimes identifies agenda subjects. The Board is alert to trends in financial reporting through observation of published reports and liaison with interested organizations. We are also alert to changes in the financial reporting environment that may be brought about by new legislation, regulatory decisions, and changing economic trends.

Those recommending Board action see opportunities for improving financial reporting in some respect. Let me mention four of the kinds of reasons why projects are added to the Board's agenda. This may give some flavor for the kind of benefits that at least some believe will result from making accounting changes. First, sometimes new standards are sought to adapt to new economic events or new transactions. Our project dealing with accounting for universal life products and for single premium annuity products is an example aimed at adapting to what some see as new and different products.

Second, standards have been proposed to modify old standards, either to correct perceived inequities or to reduce the complexity involved in applying them. Such considerations are partially involved in our income taxes project and underlie suggestions that the Board consider the whole question of discounting.

Third, sometimes new standards are sought to achieve consistency and comparability in practice. The occasion for such a change is often a perceived need for guidance in applying a new standard or a perceived need to halt the spread of what is viewed as an undesirable accounting practice. The Board's project on single premium insurance products is an example of such a project.

Finally, some new standards are thought to improve upon the availability, understandability, and comparability of publicly available information. These are the reasons why pensions, income taxes, and other post employment benefits are on the Board agenda.

Of course, these reasons are not exhaustive and some projects are added for multiple reasons. My point is that the Board initially attempts to identify the problem that needs addressing and the benefits expected to result from making a change.

After receiving suggestions for Board action, the Board must decide whether or not to add items to its formal agenda. To aid in this decision making process, the board has identified four factors to consider. These factors include:

1. Pervasiveness: This is the extent to which an issue is troublesome to users, preparers, auditors, or others; the extent to which there really is diversity of practice, and the likely duration of the problem.

2. Alternative solutions: This is the extent to which one or more alternative solutions that will improve financial reporting are likely to be developed. In accounting, as in so many other fields, it is much easier to identify the problem than to arrive at a satisfactory solution.

3. Technical feasibility: This is the extent to which a good solution can be developed on a technically sound basis. Again, it is sometimes true that problems defy technically sound solutions given the frailties of the present accounting model.

4. Practical consequences: This is the extent to which an improved accounting solution is likely to be generally acceptable, and the extent to which addressing or not addressing a particular subject might cause others to act.

These four factors are not evaluated in the same way and to the same extent in every instance. However, focusing on these criteria does help the Board make agenda decisions.

THE DELIBERATIVE PHASE

Once items are added to the Board's agenda, the deliberative phase begins. Because actions of the FASB have an impact on many organizations, the Board follows a very elaborate "due process" that is open to public observation and participation.

In identifying possible solutions to accounting problems, our staff works closely with and encourages participation by all those affected by the accounting question at issue. Thus, during our staff work on the pensions project, extensive input was received from members of the actuarial fraternity. In a similar fashion, we are seeking and obtaining extensive help from members of your group on our project on other post employment benefits.

Board deliberations are open to the public. The Board makes its tentative decisions available publicly and seeks public comment and reaction on these decisions. When proposed solutions are reached, the Board publishes its tentative recommendations in the form of exposure drafts. These are widely distributed in order to receive maximum constituent comment, criticism, and suggestions for change. Depending on the extent and nature of comments received, the Board may decide, as it has on its exposure draft on new insurance projects, to hold a public hearing. This gives the Board the chance to have direct dialogue with persons wishing to comment on proposals. All in all, a vast reservoir of information is available to the Board and its staff in the deliberative phase.

The extensive due process followed means that the Board necessarily moves slowly. In one sense this is unfortunate, since an extended time period is involved in reaching solutions to problems. But the slowness is not because of procrastination or indecision. It is, first, because the issues are complex and the answers uncertain and, second, because the process calls for the FASB to listen to every argument from every source.

The advantage of the due process is that everybody interested -- corporations, public accountants, financial analysts, actuaries, accounting educators, and others -- all have a chance to influence the Board's view as to what the appropriate accounting answer should be, both from a conceptual and from a practical view. The due process also helps assure acceptance of the standard finally adopted, since most come away feeling that they have had a fair hearing.

THE DECISION PHASE

Once deliberations are complete, and the Board has considered constituent comments and views, the Board must reach final decisions on accounting standards. Proposed solutions and final standards reflect the conclusions of at least a majority of the seven members of the Board. In reaching its decisions, the Board attempts to follow certain precepts. Let me mention three of these.

First, the Board attempts to be objective in its decision making and to ensure, insofar as possible, the neutrality of information resulting from its standards. This means that the Board attempts to measure economic activity as faithfully as possible without coloring the image in order to influence behavior in any particular direction. This point is important because the Board often hears arguments against proposed accounting changes on the grounds that the changes will have an adverse economic impact on affected enterprises.

These economic consequences are hard for the Board to factor into its decisions. The very existence of the Board depends upon the objectivity and evenhandedness of its decision making process. Our decisions must not, either in fact or in perception, directly favor one group or economic or political objective at the expense of another. Thus, the Board must look for the best measure of an economic event, independent of the fact that adopting this measure may have an adverse economic impact on some parties.

Of course, the Board must assess whether proposed accounting changes are cost-effective. It does thus attempt to understand the impact proposed accounting alternatives will have upon the financial reports of an affected company, and the cost of preparing them, so as to get some measure of the overall costs involved in making the change. In any event, neutrality and objectivity are critical to the Board's decision making process.

Second, the Board attempts to adopt accounting standards only when expected benefits exceed anticipated costs. In common with a number of concepts, the idea that benefits should outweigh costs is a lot easier said than implemented.

While benefits must be compared against costs, each is hard to measure. The costs of making a proposed change, of course, include the out-of-pocket costs of converting to the new standard, the costs of processing the information required, and possibly increases in auditing costs. So far so good. Reasonable estimates of these costs are possible. More difficult to assess are the costs incurred by all parties involved in learning to understand, digest, and adapt to new rules.

Estimating benefits is a particularly thorny problem -- one rarely accomplished with any precision. We do attempt to identify the benefits of the proposed change but the process is more qualitative than quantitative. In making its cost/benefit assessments, the Board actively seeks and welcomes input on either the benefit or the cost side of the question.

Third, the Board attempts to make needed changes in ways that minimize disruption to the continuity of reporting practice. The Board must balance the need for stability and the need for change. One of my fellow Board members says that we follow the principle of evolutionary coherence. This principle says, in a nutshell, that the world can stand only so much change at a given time. Radical change happens on rare occasions in both biological and social evolution. But mostly things evolve in small increments. In accounting, that means that changes are made in bite-size pieces.

So far, I have tried to convey some flavor of what the FASB is all about and how it goes about its business. One last point deserves mention. This concerns whether there has been any philosophical shift on the Board's part. Several members of your profession have asked me this question.

The answer is a simple "no." There has been no overt or conscious change in the Board's purpose or direction in recent years. Because Board decisions reflect the judgments of seven individual Board members, decisions reached over time do reflect the majority views of a changing Board membership. But I can assure you that there has been no deliberate attempt to shift Board direction either in the items that it will address or in the decisions that it reaches.

The Board's stated mission has been, and continues to be, the improvement of standards of financial accounting and reporting.