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News Release

Remarks to

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"Evaluating the Costs and Benefits of Accounting Standards"

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*/ The views expressed herein are those of Commissioner Lochner and do not necessarily represent the views of the other Commissioners or the Commission staff.

I'd like to speak a bit today about the relationships between mandatory financial statement disclosure rules and the U.S. securities markets, and then turn to the issue of what that relationship and other current economic realities may suggest about how proposed U.S. accounting rules should be evaluated.

Let me start with the U.S. securities markets. The U.S. securities markets are large and liquid and (Ivan Boesky and Michael Milken to one side) are generally acknowledged to operate successfully, at least in an overall sense.

The securities markets are alleged to operate successfully in some large part because of our system of disclosure to investors of information about securities issuers, and our strict enforcement of antifraud rules. Many would argue that factors such as the relative strength of our economy, and the relative stability of our legal and political system may also have had much to do with the success of our securities markets over the last half century.

Whatever the full list of factors, disclosure about issuers surely plays some part in that success. Now disclosure, of course, can take a wide variety of forms. There is disclosure about issuer products and plants, issuer patents and copyrights, issuer employees and executives, issuer customers, suppliers, and competitors, and so forth. There is also disclosure relating to issuers concerning, for example, the general economic and regulatory environment. And then, of course, there is mandated financial statement disclosure.

Is officially mandated accounting disclosure the most important part of the complete disclosure system? That question is difficult to answer with certainty. However, I suspect if one asked an ordinary investor to read a prospectus, and then gave him or her an open book exam, the investor would probably get a very low grade on the financial statements portion of the exam. But that low grade wouldn't deter that ordinary investor from buying securities.

No one, to my knowledge, seriously doubts that conclusion --- financial statements are not understandable by ordinary investors and hence don't much directly affect their investment decisions. But the ordinary investor's lack of financial statement understanding may be irrelevant. Required financial statement disclosure may be important, instead, because security analysts, who do understand financial statements, interpret the financial disclosure, make their recommendations, and are then relied upon by ordinary investors in making their investment decisions.

Of course, individual investors have been, at least in relative terms, disappearing from the securities markets in recent years. They are being replaced by institutions, which assuredly understand financial statements, even if individual investors don't. However, if the institution is an index player, or an arb or a day trader, or its market strategy is based on technical analysis rather than fundamentals analysis, then even if the institution can understand financial statements it may not have much use for them. It should be noted that such institutions appear to be increasing in number.

Even if an institution is interested in the fundamentals, the relevance of financial statement disclosure to its investment decisions may vary widely. Obviously, financial statements may be quite important to an equity investor who believes in fundamentals. But a fundamentals investor who is interested in buying a one-year note or 90-day commercial paper from an issuer may have considerably less need to know how that issuer is accounting for leases or income taxes.

Of course, commercial paper purchasers may rely on financial statements indirectly. Such purchasers may rely on commercial paper ratings given by rating agencies, which in turn rely on a review of financial statements. Even a rating agency, however, may not be much interested in pension accounting issues if it is rating 90-day paper. Alternatively, commercial paper purchasers may rely on a general belief that bad news will be disclosed; that mandated financial statements constitute part of this system of disclosure; and hence indirectly rely on such financial statements when making investment decisions.

Where, then, does that leave us? I suppose with the conclusion that the required disclosure contained in U.S. certified financial statements has some material relevance --- exactly how much we don't know --- to the operation of the U.S. securities markets for at least some investors at least some of the time. It is one strand, and certainly an important strand, in a tapestry of information made up of many strands. If this conclusion is correct --- that mandated financial disclosure is one factor (but not the only factor) in having healthy securities markets --- what does it suggest about how to evaluate the utility of new mandatory financial disclosure standards?

In answering this question I do not believe we can ignore the fact that mandating financial statement disclosure involves costs. It is, like the application of any regulation, a form of tax --- in this case one which is imposed on some of those wishing to participate in U.S. securities markets. Of course, the tax is on the issuers. All others who may make use of financial statement disclosure of others or participate in the markets --- the rating agencies, the banks and insurance companies, the mutual funds, and all the other institutional investors, and the securities analysts --- get the benefit of the markets without paying this particular tax (though they certainly pay other taxes).

We can, I suppose, justify this tax on those who seek to raise money in the securities markets if the social benefit is sufficient and the tax is not too high, even while feeling, perhaps, somewhat embarrassed at imposing this tax on, for example, a small company just to make Morgan Guaranty's or Goldman Sachs' or Prudential's life easier. But please note my qualifier --- that the tax is not too high.

Obviously, there are many costs, in addition to accounting costs, that affect a business' financial health. I am not suggesting that accounting costs are in any way determinative of the outcome of the competitive struggle. Nevertheless, I believe that it is important to look at accounting costs as an element affecting competition, and that these costs, like all other types of regulatory costs, should not be imposed on U.S. companies unnecessarily, or without sufficient thought and analysis.

The costs of mandated accounting can be minimized if standard setters carefully evaluate the impact of their standards to ensure that their costs do not exceed their benefits.

Cost/benefit analysis is a fundamental aspect of almost any endeavor, and it is particularly important in the regulatory context in order to prevent burdensome and unnecessary requirements from being imposed. This idea is not a new one, nor is the application of this notion to the adoption of new accounting standards. Indeed, cost/benefit analysis was included as part of the Financial Accounting Standards Board's mission statement at the time FASB was organized in 1973. New standards, FASB affirmed, should not be adopted unless the benefits exceed the costs.

In the last two decades, the convergence of several major trends has heightened the need for effective cost/benefit analysis of proposed new accounting standards. These trends include the internationalization of markets and a major expansion in the financial reporting requirements applicable to U.S. companies.

The steadily increasing internationalization of markets has been much commented upon, and I do not intend to belabor the point today. It is, however, worth restating the effect of internationalization on rule making.

In purely national markets where all of the relevant competitors are subject to a single regulatory scheme, competitive factors are of less significance in evaluating the costs and benefits of a new regulatory requirement which affects all competitors equally. Whatever regulations are adopted, their costs will be likely to fall, more or less, on all competitors.

However, when all competitors are not subject to the same regulatory scheme, a new factor must be added to the cost/benefit analysis: the extent to which regulated companies will be disadvantaged in their competition with similarly-situated competitors that are not subject to similar regulatory requirements.

I would not suggest that the competitive effects of an accounting standard should be the sole or even the most significant factor in determining whether an accounting standard should be adopted. It may well be that the benefits of adopting a particular standard outweigh any anti-competitive effects. My point is simply that U.S. regulators, whether in the public or quasi public sector, whether at FASB --- or, for that matter, the Department of Labor or the SEC --- no longer have the luxury of ignoring the costs imposed by their actions in an internationally competitive environment.

Moreover, the potential for accounting standards to cause competitive disparities has increased in recent years as a result of a dramatic expansion in the financial reporting requirements applicable to U.S. companies. For example, as of 1973 the Accounting Principles Board had adopted a total of 31 opinions in its fourteen year life. In the seventeen years since then, FASB has promulgated 105 new standards.

The complexity of accounting standards has increased as much as their sheer number. Recent standards have tended to be much longer and more detailed than previous ones, and more information is required to be generated to comply with the standards.

It is also worth noting that the accounting rule-making burden is likely to fall disproportionately on smaller companies which may lack the large sophisticated accounting staffs which a company like IBM would possess. And it is precisely the smaller businesses, economists suggest, that disproportionately generate innovation and jobs in our society.

In view of the dramatic expansion of financial reporting requirements, it would seem an appropriate time to take a step back and evaluate their cumulative effect, and to assess whether the benefits of the boom in financial reporting have exceeded the costs.

The fullest theoretical discussion that FASB has produced concerning the costs and benefits of accounting standards appears to be found in its Concepts Statement No. 2. The Statement's itemization of the benefits of accounting standards reflects a broad scope. Benefits are said to include more efficient allocation of resources, for example, and improved access to the capital markets for preparers.

The costs of accounting standards seem to be viewed somewhat less broadly in FASB's Concepts Statement.

While the loss of competitive advantages is mentioned, its cost is referred to as "clearly in a different category" from other costs involved, and is said to be a cost that is nearly impossible to begin to quantify. Indeed, the Concepts Statement emphasizes several times that most of the benefits and costs of accounting standards cannot be precisely calculated, and that the merits of accounting standards can only be decided by judgments that are largely subjective.

How does one deal with the difficulty of evaluating and, in particular, quantifying the costs and benefits of accounting standards?

There is no doubt that analyzing the costs and benefits of accounting standards is a difficult task, and that often it will be impossible to quantify many of the costs and benefits. In view of the importance of the task, however, its difficulty does not provide any justification for not evaluating costs and benefits to the greatest extent possible. In particular, the difficulty of quantification should not mean that unquantifiable costs are presumed to be inconsequential, while unquantifiable benefits are presumed to be important --- or, for that matter, the other way around.

The difficulty of quantifying the costs and benefits of accounting standards only heightens the need for public and private standard setters to provide an explicit and systematic cost/benefit analysis of their actions. At the least, this analysis should include an itemization of all of the costs and benefits associated with a standard and a discussion of how the standard setter views their relative significance.

It also would be helpful if standard setters could publish such a cost/benefit analysis at every stage in the standard-setting process, including at the time they decide to add an item to their agenda.

Cost/benefit considerations deserve, to the same extent as technical accounting issues, to be exposed fully to the notice and comment process.

Publishing a comprehensive cost/benefit analysis could enhance commenters' understanding of FASB's thinking concerning a standard, help focus comments and, perhaps, generate greater confidence in FASB's decisions. In addition, it could help avoid the unfortunate situation in which after a standard is adopted, it must be amended or have its effective date delayed in order to address apparent and significant cost/benefit problems.

It is important to remember, I believe, that accounting standards are not immutable laws of nature, but human conventions created in an attempt to approximate reality. They cannot do so perfectly.

Accordingly, standard setting generally should be viewed as finding the preferred choice within a range of reasonable possibilities, rather than as finding the one "right" answer. In choosing within a range of reasonable accounting approaches that have roughly comparable benefits, the relative costs of the approaches should receive substantial weight.

Moreover, in evaluating the benefits of a proposed new standard, it is not sufficient to conclude merely that the standard will help produce results that more closely align with a theoretical accounting construct. Standard setters must ascertain whether, and to what extent, the standard produces information that will actually be used by investors, securities analysts, management, creditors and others in analyzing a company's financial condition. The usefulness of different standards will vary significantly, and, consequently, so will the offsetting costs that they can justify.

Another important part of an appropriate evaluation of the costs and benefits of an accounting standard is to not ignore or underestimate the costs of adopting any new standard. The costs of changing standards include the costs of monitoring the actions of standard setters, learning about new standards, and implementing new systems and procedures to generate required information. Costs of change also include contracting costs, such as the cost of renegotiating the terms of loan agreements to accommodate the results produced by changed accounting standards. Finally, changing a standard often results in managers focusing their attention on financial reporting matters to the detriment of other, perhaps ultimately more productive, pursuits.

While the costs of change were not as significant when accounting standards were relatively stable and less complex, in recent years the constant succession of major accounting standards that have been proposed, reviewed or adopted has transformed what had been a relatively isolated and small cost into a recurring and more substantial cost. The cumulative effect of continual change must be included in a full analysis of the costs and benefits of new standards.

One hears that accounting standard setters should not consider the more broadly defined costs of standard setting because the purpose of accounting standards should not be to reach results that favor one company over another, one industry over another, or one country over another. This assertion is so evidently correct as to defy contradiction, and I have not heard anyone reasonably contend that it should be the purpose of accounting standards to favor, for example, the steel industry over the automobile industry.

I do not believe, however, that attempting to avoid imposing unnecessary regulatory costs is the same as intentionally crafting regulations to bestow favors on a particular economic interest. Nor should standard setters turn a blind eye to the wider impact of what they do. Every accounting rule will affect some issuers in one way, and others in another. To say otherwise is to refuse to deal with reality.

One also hears that if standard setters consider the broader range of costs of what they do, we will wind up with the kind of accounting principles that permitted S&Ls to conceal loan losses and bad investments, inflate their earnings, and misrepresent their true net worth.

While there are a number of responses to this concern, perhaps it is best simply to note that encouraging standard setters to consider all costs as well as all benefits in their cost/benefit analysis does not mean they should engage in bad cost/benefit analysis. Moreover, does the possibility that considering economic consequences could produce bad cost/benefit analysis justify an approach that prohibits any consideration of what can be very real and substantial costs, and thereby may result in equally bad cost/benefit decisions? I think not.

A preferable approach may be just to recognize that the issues are difficult and to deal with them as straightforwardly, systematically, openly and publicly as possible.

In conclusion, I would like to emphasize that my concern with adequate evaluation of the costs and benefits of accounting standards should not be construed as an attack on the need for any standards or as disregard for the critical importance of financial reporting. Full and fair financial disclosure has been an integral part of the development of our efficient and successful securities markets, which has enhanced the capital-raising ability of U.S. business, among other benefits.

The question is not whether there should be full and fair disclosure. Rather, in an era when U.S. companies must deal with a steadily increasing financial reporting burden, intense international competition, and significant overall cost pressures, the question is how does one determine the point at which the marginal cost of additional financial reporting requirements begins to exceed the benefits. Does the solution to better understanding of the financial condition of companies lie in financial statements or in other forms of disclosure such as the

MD&A? And how can we best balance the costs of mandated accounting disclosure against the benefits?

I can't claim that these questions are easy ones or that I have any ready answers. I do believe the questions are well worth asking.

Thank you.