FINANCIAL REPORTING WATCH™
FINANCIAL REPORTING WATCH MONTHLY ▪ APRIL 2005

FASB Must Weigh Costs and Benefits of Accounting Changes Expected in 2005

by Ben Neuhausen and Rosemary Schlank

Benjamin Neuhausen and Rosemary Schlank of BDO Seidman LLP list accounting changes that are expected from the Financial Accounting Standards Board in 2005 and detail costs and benefits that FASB should consider.

Date: Apr. 1, 2005

Full Text Published by taxanalysts™

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Another Year of Incremental Change at FASB?

If the Financial Accounting Standards Board continues on its current course, 2005 is likely to go down in accounting history as another year of "incremental change." FASB member Ed Trott coined the phrase at the March 2005 meeting of the Financial Accounting Standards Advisory Council (FASAC). He said FASB must often balance a mix of incremental and "big bang" changes when setting the scope of its projects and managing the pace and extent of future changes in accounting standards. The balance can be tough to maintain in a changing environment, and a case could be made that FASB should rethink parts of its conceptual framework and revisit the basic objectives of standard-setting in light of the developments of the past few years. If that case prevailed, the result could be a shift in direction that will alter the outcome of standards-setting in 2005 and for years to come.

Incremental vs. Big Bang Changes

The driving forces behind the support for a shift in direction at FASB are the events and trends of the past few years that have cast a spotlight on the costs, benefits, risks, and rewards of credible financial reporting. Those forces include major frauds and bankruptcies, new reporting requirements on internal controls, tougher enforcement of state laws, a reenergized Securities and Exchange Commission, and continuing technological advances.

All those developments happened outside FASB's offices in Norwalk, Conn., but they reinforce the need for accounting standards that are understandable and easy to implement, audit, and control. Those challenges could easily prove too much to ask from a project portfolio geared toward incremental change. Trott defines incremental change as a series of fast fixes for narrow issues. He believes a shortcoming of the approach is that the accumulation of serial decisions can add to the complexities and inconsistencies in the accounting literature.

The way to cut through the complexities and inconsistencies is with what Trott calls big bang solutions. The goal of that approach is to try to address accounting issues more comprehensively, such as establishing new standards for all transactions with similar economic effects. The problem with big bangs is that the needed improvements often take longer, and the costs and risks can be more visible and easier for critics to identify and oppose.

Building on Breakthroughs

Visibility aside, the bottom line is that regardless of which approach is used--big bang or incremental--any new accounting standard can prove costly to implement, and the costs can outweigh the benefits. Conceptually, it would seem FASB should have a long-term plan that would include some process for managing that risk. If it does, board members have not yet revealed that plan to their constituents. It's not too late for the board to alter the near-term outcomes of expected changes by building on the breakthroughs of the past few years and factoring into FASB's decisions a more rigorous and comprehensive cost/benefit analysis.

Below are a few accounting changes expected in 2005, along with our thoughts on the costs and benefits that should be considered.

1. The Promise of Principles-Based Standards

The elusive goal of principles-based standards will help shape standards issued in 2005 and beyond. We expect FASB will continue to look for ways to make its standards less rules-based and more principles-based or objectives-oriented.

But real progress will demand more innovative thinking to define the goals and measure the risks and rewards more precisely. Today's renewed emphasis on internal controls may pay unexpected dividends in that regard. In the past, some standards may have been rushed into effect, resulting in transition times that are too short to put the needed controls in place. Others may have required processes or systems that were costly to control and audit.

FASB's cost/benefit analysis should include the risks and consequences of making the wrong judgment or arriving at the wrong interpretation, despite a good-faith attempt to comply with principles-based standards. Just as important, the benefits analysis should focus on the needs of the users of financial statements, as well as the cost of increased complexity to everyone involved in the financial reporting process. It should also consider the values of different types of information to different classes of users, rather than weight the benefits to one class of users more heavily than others.

2. More Changes From International Convergence

The application of a more rigorous cost/benefit analysis will be especially important when weighing the need for additional projects designed to converge U.S. standards with international standards. The entire process of convergence is likely to create an ongoing source of incremental change that adds to the burden on private, small, and midsize companies and causes complexities for large companies as well. Here are some examples:

- Accounting Changes. An exposure draft on accounting changes and error corrections was released in late 2003. If adopted as a final standard, the proposed standard would require that voluntary changes in accounting policies be applied by retrospective application and that retrospective application be used as the standard transition method for new accounting standards, unless a new pronouncement contains other transition guidance. The proposal has met with resistance from those who fear restatement has taken on unfavorable connotations among users of financial statements. The concern is that these perceptions can be strong enough to outweigh any benefits of convergence on the issue.
- Research and Development. Although no timetable has been set, FASB agreed in 2004 to try to eliminate differences with the international accounting standard for research and

development. The focus is on the requirements for initial recognition of intangible assets acquired in transactions other than a business combination. A basic difference between U.S. GAAP and International Financial Reporting Standards is that the international standard distinguishes between research and development and sometimes requires capitalization of development costs, whereas U.S. GAAP makes no distinction between research and development and generally requires both types of costs to be expensed when incurred. The two boards may try to build on the thinking in FASB Statement No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed," as a framework for capitalizing internally generated intangible assets.

- Income Taxes. An exposure draft on accounting for income taxes is expected in 2005. The purposes of the draft are to (1) eliminate some of the exceptions to the comprehensive deferred tax asset and liability principles of Statement 109 (for example, FASB has tentatively decided to eliminate the exceptions for intercompany transfers and foreign currency translation), and (2) address some structural differences with the international standard. Those differences involve the use of backward tracing for interperiod tax allocation and the deferred tax assets arising in asset acquisitions other than a business combination. Convergence on income taxes may prove difficult as the standards continue to respond to other events and trends. FASB also plans to issue an interpretation to address the accounting for uncertain tax positions in 2005.

3. More Consistent Accounting for Uncertain Tax Positions

FASB’s project on uncertain tax positions was undertaken to eliminate diversity in how companies account for tax-advantaged transactions. The important issue is how to handle positions taken on tax returns that may not be ultimately sustained on audit. That issue is complicated by the fact that the probability of sustainability can change over time in response to changes in judgments and IRS interpretations.

FASB is thinking of the issue as one of how to measure uncertainty when its fair value model doesn’t apply. The board has tentatively concluded that the appropriate surrogate model would involve recognition of tax benefits when they are probable of being sustained upon examination by the taxing authorities; conversely, derecognition would occur when it is more likely than not that the position won't be sustained.

The model responds to concerns raised by the SEC in late 2003 about realization of aggressive tax positions. The potential benefits include more consistency in how public companies report those positions. However, the costs can be substantial for some companies, especially given the tentative disclosure requirements.

Under FASB’s model, companies would have to disclose any tax benefit that was filed in the company’s tax return but is not probable of realization. In making those disclosures, companies would have to assume the return will be audited by the IRS, meaning they would be precluded from factoring into their calculations the possibility that an exposure may go undetected.

Although no formal proposal has yet been issued, FASB has already received unsolicited letters commenting on the likelihood of providing a road map for IRS audits. Other relevant costs include the level of documentation that would be required to make the reporting auditable. If there is no clear tax law or tax case citation, companies may have to incur costs for transfer pricing studies, opinion letters from lawyers, or other forms of documentation that would then have to be reviewed by the company’s auditor. One bright spot is that FASB has moved away from its earlier proposal to require companies to reaffirm the probability of realization annually. Even so, a comprehensive analysis of the costs and benefits will be very difficult.

FASB has instructed the staff to draft a proposed interpretation for vote by written ballot, and issuance is expected shortly.

4. A Bridge for the Gaps in Fair Value Measurement

The use of fair value measurement is an area in which the costs and benefits have been difficult to measure. In what some have likened to the calm before the storm, FASB in 2004 released an exposure draft of a proposed statement on fair value measurement. The intent of the proposed statement is not to introduce any new requirements for the use of fair value, but to provide uniform guidance on the definition and measurement of fair value.

The number of statements that require the use of fair value continues to grow, and the concept of fair value continues to evolve. FASB believed it was time to bridge the gaps in the literature and reconcile the inconsistencies that have developed. Critics of fair value measurement fear that, if and when a final statement is issued, it may serve as a signal to expand the use of this principle and move more elements of financial reporting into the world of fair value measurement.
We are encouraged by the body of literature that is developing around the auditing of fair values. We hope the use of fair values won't be expanded without weighing all the relevant risks and rewards in a rigorous cost/benefit analysis.

5. New Rules for Contingent Asset Retirement Obligations

In 2004 FASB issued an exposure draft of a proposed Interpretation on Accounting for Conditional Asset Retirement Obligations. The biggest change in practice that would result from the draft is that the fair value of a conditional asset retirement obligation would be recognized when the obligation is incurred or as soon as the liability's fair value can be reasonably estimated.

A conditional asset retirement obligation is a legal obligation to take some actions if and when a tangible long-lived asset is retired. An example would be the legal obligation to remove and dispose of asbestos when a building is renovated or demolished. In that example, the asset retirement activity is viewed as conditional because it depends on a future event--renovation or demolition.

Current practice regarding those obligations is mixed. Some companies interpret Statement 143 and Concepts Statement 6 to say that no liability exists until the triggering event becomes probable. Others have interpreted the literature to say that a liability exists and the probability of the triggering event affects the amount of the liability. The exposure draft embraces the second interpretation (that is, a liability exists because of the legal obligation, and that probability affects the measurement of the liability at fair value). In effect, this is a purer fair value model.

Despite its seemingly purer conceptual basis, the use of fair values for conditional future events is not without hazards, mostly because it introduces into the financial statements more risks and uncertainties associated with future events. Companies are protected from liability by the safe harbor for forward-looking information provided in the Private Securities Litigation Act of 1995, if they use appropriate cautionary language to identify the risks and uncertainties. But that safe harbor does not extend to financial statements. Because the cost of making a good-faith mistake could be substantial, we believe the risk should be weighed carefully against the benefits.

6. Changing the Model for Business Combinations

Similar to the position taken by FASB on contingent asset retirement obligations, the tentative conclusions of Phase II of the FASB business combinations project reflect a more purist fair value approach. That is reflected in the potential changes proposed for application of the purchase method and for minority interests.

- Potential Changes in Applying the Purchase Method of Accounting for Business Combinations. FASB's current thinking is that future accounting for business combinations would differ from today's accounting in several important respects. Under today's purchase accounting method, the acquirer starts with the purchase cost, including direct transaction costs, and allocates it to the acquired assets and liabilities based on relative fair values. There are exceptions, such as contingent consideration, which generally isn't recorded until the contingency is resolved. In contrast, the proposed approach excludes transaction costs from purchase cost (because FASB reasons that transactions costs don't represent part of the fair value of the acquired business). It also requires the buyer to estimate the fair value of contingent consideration and record it as a liability as part of purchase accounting. Any difference between fair value estimated at closing and actual payments would be an adjustment to the income statement because it would represent subsequent changes rather than fair value at the purchase date. The guidance on individual acquired assets and liabilities is also more detailed and intended to be closer to true fair value rather than an allocated amount.

- Potential Changes in Accounting for Minority Interests. Minority (noncontrolling) interests in consolidated subsidiaries would be classified as a component of equity rather than as a liability. As proposed by FASB, this approach would substantially change the accounting for step acquisitions and dispositions. The important differences: (1) A company that previously owned a noncontrolling interest in an entity would adjust that investment to fair value and recognize a gain or loss upon achieving control; (2) Upon achieving control, the noncontrolling interest would be recorded at fair value, not at carryover basis; (3) Further purchases after gaining control would be treasury stock transactions; and (4) No gain or loss would be recorded on partial dispositions unless they resulted in losing control.
- Next Steps. FASB has posted its tentative conclusions on the project to its Web site. Our initial reaction is that on the whole, the proposed changes are a step backwards, imposing heavy costs on both preparers and users of financial statements with little benefit.