EFRAG

European Financial Reporting Advisory Group

# Considering the Effects of Accounting Standards

## Discussion Paper

JANUARY

2011

# CONSIDERING THE EFFECTS OF ACCOUNTING STANDARDS

**DISCUSSION PAPER**

**JANUARY 2011**

*The purpose of the discussion paper is to stimulate debate on the issues presented.*

*The paper is issued by the UK standard setter, the Accounting Standards Board (ASB), and the European Financial Reporting Advisory Group (EFRAG).* ***EFRAG does not formulate preliminary views at this stage of the due process.***

*The issue of this paper is also supported by the following standard setters in Europe:*

*OIC – Organismo Italiano di Contabilità (Italy)*
*DRSC – Deutsches Rechnungslegungs Standards Committee (Germany)*
*RJ - Raad voor de Jaarverslaggeving (Netherlands)*
*KSR- Komitet Standardów Rachungkowości (Poland)*
*ICAC - Instituto de Contabilidad y Auditoría de Cuentas (Spain)*
*FSR - Foreningen af Statsautoriserede Revisorer (Denmark)*

## DISCLAIMER

***These bodies, while encouraging debate on the issues presented in the paper, do not express any opinion on those matters at this stage.***

*Copies of the paper are available from the websites of those bodies issuing the paper. A limited number of copies of the paper will also be made available in printed form, and can be obtained from either the ASB or EFRAG.*

***The paper invites comment on its proposals via the 'Questions for Respondents' at the end of each section (which are summarised in the Appendix). Such comments should be sent by email to:***

***commentletters@efrag.org or***

***by post to:***

***EFRAG***
***35 Square de Meeûs***
***1000 Brussels***
***Belgium***

***so as to arrive no later than 31 August 2011. All comments received will be placed on the public record unless confidentiality is requested.***

## Proactive Work in Europe

EFRAG aims to influence future standard setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. This proactive work is done in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at a European level.

There are four strategic aims that underpin proactive work:

- Engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- Influencing the development of global financial reporting standards;
- Providing thought leadership in developing the principles and practices that underpin financial reporting; and
- Promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our proactive work and current projects is available on the EFRAG website (www.efrag.org).

*"IA [impact assessments] and BCA [benefit-cost analysis] are tools, not rules. They are mechanisms to inform decision making, not the decision itself. The decision itself is and must be an exercise of judgment by a public official. Policy must be based on and express that judgement, rather than be dictated by a cold numerical calculus. At the same time, that public policy judgement will often be better made when it is informed by a careful structured comparison of consequences…"*
(Jonathan Wiener, 2006)

*"We standard setters are besieged with admonitions to move cautiously because of the economic consequences of our actions. We are told that we should ascertain consequences before we pronounce. I suspect that if we were required to ascertain consequences, including perceived rippling effects, before issuance, we would never pronounce. But that is far from saying that we should be cavalier about the impact of what we do or that we should not be mindful of the likely consequences. On the contrary, concern about economic consequences should be central to the role of financial reporting and to the mission of standard setters."*
(Oscar Gellein, 1978)

*"What is abundantly clear is that we have entered an era in which economic and social consequences may no longer be ignored as a substantive issue in the setting of accounting standards. The profession must respond to the changing tenor of the times while continuing to perform its essential role in the areas in which it possesses undoubted expertise."*
(Stephen Zeff, 1978)

*"We firmly believe that improvements in accounting standards can help promote global financial stability and sound economic growth by enhancing transparency, reducing complexity and restoring confidence that the extent of losses in the financial system has been recognized and disclosed."*
('Report of the Financial Crisis Advisory Group', 2009)

## CONTENTS

## PURPOSE AND SUMMARY OF THIS DISCUSSION PAPER

### Purpose of this discussion paper

1 The issue of whether accounting standard setters should take account of the effects, or consequences, of the standards they develop has been a subject of debate for decades, although without satisfactory resolution. As explained in Section 1, the issue has become more prominent in recent years and the requirement for an analysis of the anticipated effects of a new International Financial Reporting Standard (IFRS) or a major amendment to an IFRS is now included in the 'Due Process Handbook for the IASB'[1]. Whilst acknowledging the progress that has been made, there remains pressure from some quarters for the International Accounting Standards Board (IASB), and other national standard setters, to further develop and formalise the role of effects analysis as a mandatory part of its due process.

2 The purpose of this paper is to put forward, for public comment, proposals to integrate (or further embed) into the standard setting due process a systematic process for considering the effects of accounting standards as those standards are developed and implemented. The intention is to stimulate discussion and to use the consultation process to assess support for the proposals, with a view to then assisting the IASB in implementing the proposals within its due process.

3 This paper is concerned primarily with the due process of the IASB, but the content of this paper will also be relevant to national standard setters.

### Executive summary

4 The content of this paper is as follows:

- Section 1 provides background information;
- Section 2 explores the process of 'effects analysis';
- Section 3 explores the concept of 'effects';
- Section 4 considers the key principles underpinning effects analysis;
- Section 5 considers the practicalities of performing effects analysis; and
- Section 6 contemplates next steps.

[1] International Accounting Standards Committee Foundation (IASCF) (2008), *Due Process Handbook for the IASB*.

### *SECTION 1: Background*

5 Section 1 provides an overview of the context and circumstances which have given rise to the proposals put forward in this paper. It highlights a number of relevant public policy considerations, including calls by the European Commission and others for the IASB to undertake an analysis of the effects of accounting standards, the policy laid down by the International Financial Reporting Standards Foundation (IFRS Foundation)[2] for the IASB to do this, the global financial crisis and ongoing international adoption of IFRSs (paragraph 1.6).

### *SECTION 2: The process of 'effects analysis'*

6 Section 2 explores the process of 'effects analysis'. A key proposal is that 'effects analysis' should be defined, for the purposes of accounting standard setting, as 'a systematic process for considering the effects of accounting standards as those standards are developed and implemented' (paragraph 2.2), and it is clarified that effects analysis is not merely a document or a single point-in-time event (paragraph 2.4).

7 Section 2 sets out a number of other preliminary views:

- Effects analysis should be integrated (or further embedded) into the standard setting due process (paragraph 2.7), the main aims being to strengthen that process and enhance its transparency, to increase the accountability and credibility of the standard setter, and thus to contribute positively to delivering improved financial reporting (paragraph 2.8);
- The standard setter should be responsible for performing effects analysis (paragraph 2.11);
- Effects should be considered throughout the life-cycle of a project to introduce a new accounting standard or amendment, but publication of a document setting out the key elements of the effects analysis should be specifically required at defined points in that life-cycle (paragraph 2.15); and
- Effects analysis should be undertaken for all new accounting standards or amendments, but the depth of the analysis work should be proportionate to the scale of the effects, the sensitivity of the proposals and the time available (paragraph 2.19).

### *SECTION 3: The concept of 'effects'*

8 Section 3 explores the concept of 'effects'. A key proposal is that 'effects' should be defined, for the purposes of accounting standard setting, as 'consequences

[2] The IFRS Foundation was formerly known as the International Accounting Standards Committee Foundation (IASCF).

that flow, or are likely to flow, from an accounting standard, referenced against the objective of serving the public interest by contributing positively to delivering improved financial reporting' (paragraph 3.2).

9 Section 3 sets out a number of other preliminary views:

- The term 'effects', rather than the term 'costs and benefits', should be used to refer to the consequences of accounting standards on the grounds that it would not be appropriate to require a quantified cost benefit analysis to be applied to standard setting (paragraph 3.7);

- The scope of 'effects' to be considered, for the purposes of performing effects analysis, should include all effects, both 'micro-economic effects' and 'macro-economic effects' (paragraph 3.12); and

- A standard setter can only be expected to respond to an effect which is outside of its remit (or for which an accounting standard is not the most effective means of addressing the particular effect) by communicating with the relevant regulator or government body to notify them of the relevant issue and to obtain confirmation from them that they will respond appropriately to it (paragraph 3.17).

- (Further preliminary views, which provide subtle refinements to the concept of 'effects', are included in paragraphs 3.19, 3.23, 3.24, 3.26, 3.28, 3.30 and 3.32.)

## *SECTION 4: The key principles underpinning effects analysis*

10 Section 4 considers whether there should be a set of key principles underpinning effects analysis, and what those principles should be. The proposal is that there should be a set of key principles underpinning effects analysis, and that those principles should be as follows (paragraph 4.2):

> ***Principle 1:*** *Explain intended outcomes*
> Standard setters should explain the intended outcomes of a proposed accounting standard or amendment in terms of their objective of serving the public interest by contributing positively to delivering improved financial reporting. This should be done at the agenda-setting stage;
>
> ***Principle 2:*** *Encourage input on anticipated effects*
> Constituents should be actively encouraged to provide input on anticipated effects, which should be considered against the standard setter's objective;
>
> ***Principle 3:*** *Gather evidence*
> The evidence gathered should demonstrate that the proposals faithfully represent the underlying economic reality and produce information that has utility for users. Effects should be quantified where such quantification is practicable and is likely to be useful to decision-making; and

***Principle 4:*** *Consider effects throughout the due process*
Consideration of the effects of an accounting standard or amendment should occur throughout the standard setting process; it should be embedded in that process and not considered as a single event.

### *SECTION 5: The practicalities of performing effects analysis*

11 Section 5 considers the practicalities of performing effects analysis. It sets out a number of preliminary views regarding the process that a standard setter should apply for:

- Validating the intended outcomes of a proposed accounting standard or amendment (paragraph 5.2);
- Identifying and assessing the effects of a proposed accounting standard or amendment (paragraph 5.3); and
- Identifying options for the proposed accounting standard or amendment, and choosing the preferred option (paragraph 5.4).

12 Section 5 also proposes that the IASB should, to some degree, delegate to national standard setters and similar institutions some of the activities involved in gathering evidence of the effects of accounting standards, particularly consultation with constituents, and that these bodies should play a more active part in the due process to ensure that IFRSs contribute positively to delivering improved financial reporting (paragraph 5.5).

### *SECTION 6: Next steps*

13 Section 6 contemplates next steps. It proposes the next steps in developing and, subject to the results of public consultation, implementing the proposals put forward in this paper (paragraph 6.2).

## SECTION 1: Background

### Introduction

1.1 This section provides an overview of the context and circumstances which have given rise to the proposals put forward in this paper. The main premise of the proposals is that standard setters should integrate (or further embed) into their due process a systematic process for considering the effects of accounting standards as those standards are developed and implemented.

### Context and circumstances: why consult now?

1.2 A key tenet of policy making is that policy makers should gather evidence and test their proposals prior to implementation, and that they should subsequently assess the effectiveness of the proposals after implementation. Evidence-based policy making is now accepted practice in many economic, financial and social policy areas.

1.3 Should standard setters be able to answer basic questions concerning the anticipated consequences of their proposals? What does the standard setter expect the consequences of a new accounting standard to be, and why? Once the standard has been implemented, have the anticipated consequences materialised and should corrective action be taken? The issue of whether accounting standard setters should take account of the effects, or consequences, of the standards they develop has been a subject of debate for decades (refer to paragraphs 2.9 and 2.10), although without satisfactory resolution.

1.4 In recent years, the issue has become more prominent. In April 2007, the Trustees of the then International Accounting Standards Committee Foundation (IASCF)[3] announced that "*it would be beneficial to develop a more explicit framework for evaluating the relative costs and benefits of its proposals and that this framework should become part of the IASB's due process*"[4]. The requirement for an analysis of the anticipated effects of a new IFRS or a major amendment to an IFRS is now included in the Foundation's 'Due Process Handbook for the IASB', as approved by the Trustees in October 2008.

1.5 The main aims of integrating (or further embedding) such 'effects analysis' into the standard setting due process are to strengthen that process and enhance its transparency, to increase the accountability and credibility of the standard setter, and thus to contribute positively to delivering improved financial reporting. The IASB's experience to date in preparing effects analyses has been in two main areas, both of which are linked to a further requirement to prepare feedback statements:

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[3] The IASCF has since been renamed as the International Financial Reporting Standards Foundation (IFRS Foundation).

[4] International Accounting Standards Committee Foundation (IASCF) (2007), *Press Release – Summary of the IASC Foundation Trustees meeting April 2007*.

1. Business Combinations Phase II ‘Project summary, feedback and effect analysis’[5] (January 2008); and

2. IFRS 9 ‘Project Summary and Feedback Statement’[6] (November 2009).

1.6 The term ‘effects analysis’ is gaining currency in standard setting, possibly in response to concerns that quantified cost benefit analysis is not always appropriate for standard setting. Accordingly, the IASB Conceptual Framework[7] should be updated to reflect this evolution. Whilst acknowledging the progress that has been made, there remains pressure from some quarters for the IASB, and other national standard setters, to further develop and formalise the role of effects analysis as a mandatory part of its due process. For example:

- The European Commission has emphasised the need for effects analysis to play a more important and formal role in the due process of the IASB;

- The endorsement process for the adoption of IFRSs within the European Union requires an effects study to be carried out. This task is currently undertaken by the European Financial Reporting Advisory Group (EFRAG); when EFRAG restructured its governance arrangements in 2008, however, it anticipated that it would increasingly rely on the effects analysis undertaken by the IASB;

- The IASB has made a commitment to undertake post-implementation reviews of its major projects, which is an analysis of effects that is performed after an accounting standard has been in place for a number of years;

- The global financial crisis engendered a debate on the potential effects of accounting standards on financial stability, and sharpened interest in whether the standard setting process is effective in contributing positively to delivering improved financial reporting; there is perhaps a significant ‘expectation gap’ concerning what standard setters are able to do and what effects they are able or best placed to respond to;

- Ongoing international adoption of IFRSs has increased the importance of the IASB being able to demonstrate that it has considered the effects of accounting standards in making its decisions, in view of the increasingly far-reaching consequences of those decisions across the globe;

- There are calls from users, for example the Corporate Reporting User Forum (CRUF), for standard setting proposals to be more evidence-based; and

- There is a general view in many jurisdictions that all regulators should attempt to assess the effects of their decisions, and that the standard setting process

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5 International Accounting Standards Board (IASB) (2008), *Business Combinations Phase II – Project summary, feedback and effects analysis*.

6 International Accounting Standards Board (IASB) (2009), *Project Summary and Feedback Statement – IFRS 9 Financial Instruments – Part 1: Classification and measurement*.

7 International Accounting Standards Board (IASB) (2010), *Conceptual Framework for Financial Reporting 2010*.

should be brought into line with other processes of regulation. However, a considered approach is critical if standard setters are to avoid the difficulties encountered by other processes of regulation, particularly as there is a lack of sufficiently well-established and reliable techniques for assessing the effects of accounting standards.

1.7 Given the above considerations, the Planning and Resources Committee of EFRAG agreed that the topic of effects analysis should be examined as a European proactive project. This paper is the output of that examination.

## SECTION 2: The process of 'effects analysis'

### Introduction

2.1 This section explores the process of 'effects analysis'; it includes the following:

A. Definition of 'effects analysis';

B. The case for integrating (or further embedding) effects analysis into the standard setting due process;

C. Responsibility for performing effects analysis;

D. Frequency and timing of effects analysis; and

E. Proportionality in performing effects analysis.

### A: Definition of 'effects analysis'

2.2 The preliminary view is that 'effects analysis' should be defined, for the purposes of accounting standard setting, as 'a systematic process for considering the effects of accounting standards as those standards are developed and implemented'. (The precise meaning of 'effects' is explored in Section 3, and a definition is provided in paragraph 3.2.)

2.3 This paper uses the term 'effects analysis' and not the related term 'impact assessment'. This is deliberate, as effects analysis as envisaged by this paper is not intended to be identical to an impact assessment. The term 'impact assessment' is used in a broader regulatory context beyond accounting standard setting, and it is not the intention of this paper to create a requirement to complete a comprehensive impact assessment, as this often involves a quantified cost benefit analysis. The preliminary view set out in paragraph 3.7, then discussed in paragraphs 3.8 to 3.10, is that it would not be appropriate to require a quantified cost benefit analysis to be applied to accounting standard setting.

2.4 It should be noted that 'effects analysis', as defined in paragraph 2.2, is a 'process'. It is integrated within the standard setting process and is not merely a document or a single point-in-time event (refer to paragraph 4.7).

2.5 Question 1, at the end of this section, asks the reader to comment on the above definition of 'effects analysis' for the purposes of accounting standard setting. To assist the reader in considering this question, an IASB definition of 'effects analysis', the European Commission definition of the related process of an 'impact assessment' and the UK BIS (Department for Business, Innovation and Skills) definition of an 'impact assessment' are provided below.

- An IASB definition of an 'effect analysis' in the 'Due Process Handbook for the IASB', issued in October 2008:

  "*…an analysis of the likely effects of the forthcoming IFRS or major amendment.*"[8]

- The European Commission definition of an 'impact assessment' in the 'Impact Assessment Guidelines', issued on 15 January 2009:

  *Impact assessment is a set of logical steps to be followed when you prepare policy proposals. It is a process that prepares evidence for political decision-makers on the advantages and disadvantages of possible policy options by assessing their potential impacts.*[9]

- The UK BIS definition of an 'impact assessment' in the 'Impact Assessment Guidance', issued in November 2010:

  *An Impact Assessment is both:*
  - *A* tool *used by policy makers to assess and present the likely costs and benefits (monetised as far as possible) and the associated risks of a proposal that might have an impact on the public, private or civil society organisations, following Green Book's*[10] *appraisal and evaluation techniques.*
  - *A* continuous process*, consistent with the policy appraisal cycle, as set out in the Green Book, to help policy makers to fully think through the reasons for government intervention, to weigh up various options for achieving an objective and to understand the consequences of a proposed intervention.*[11]

2.6 The reader should consider Sections 2 and 3 of this paper, in their entirety, prior to answering Question 1, or indeed any other question at the end of this section.

## B: The case for integrating (or further embedding) effects analysis into the standard setting due process

2.7 The preliminary view is that effects analysis should be integrated (or further embedded) into the standard setting due process.

2.8 The main aims of integrating (or further embedding) 'effects analysis' into the standard setting due process are to strengthen that process and enhance its transparency, to increase the accountability and credibility of the standard setter,

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8 International Accounting Standards Committee Foundation (IASCF) (2008), *Due Process Handbook for the IASB*.

9 European Commission (2009), *Impact Assessment Guidelines*.

10 The Green Book, produced by HM Treasury in the UK, sets out the UK Government's appraisal methodology for the economic assessment of the social costs and benefits of all new policies, projects and programmes, including the economic assessment of regulations under regulatory impact analysis.

11 Department for Business, Innovation and Skills (BIS) (2010), *Impact Assessment Guidance*.

and thus to contribute positively to delivering improved financial reporting. In particular, standard setters may make informed decisions by applying ‘effects analysis’ to systematically assess effects, consult with constituents and put together a comprehensive body of robust evidence to support those decisions, such that standard setters are thus readily able to demonstrate that their activities are contributing positively to delivering improved financial reporting.

2.9 It could be argued that the main aims of integrating (or further embedding) ‘effects analysis’ into the standard setting due process, as discussed in paragraph 2.8, can instead be achieved via existing or enhanced governance arrangements or via other changes to the standard setting due process, supported by the safeguard of exposing proposed requirements for public comment prior to their implementation. Some might consider the existing governance arrangements of the IASB, together with an extensive consultation process, to be sufficient to ensure that accounting standards and amendments are adequately scrutinised by relevant individuals who will ensure that those standards and amendments are fit for purpose, such that effects analysis is not necessary. In response, it might be observed that governance arrangements are no substitute for proper stakeholder engagement throughout the standard setting process, and that governance arrangements do not obviate the need for standard setters to base their decisions on a broad evidence base and to actively demonstrate that they have discharged their obligation to demonstrate that their activities are contributing positively to delivering improved financial reporting.

2.10 Arguments in favour of integrating (or further embedding) effects analysis into the standard setting due process are listed below, together with their counter-arguments; it should not be assumed that this is an exhaustive list. Arguments ‘a’ to ‘c’ concern transparency, accountability and credibility, and thus are a subset of the main aims of integrating (or further embedding) ‘effects analysis’ that were considered in paragraph 2.8, whereas arguments ‘d’ to ‘f’ are additional.

a) *To respond to requests from governments and other policy-makers, including the European Commission and IFRS Foundation*
Governments and other policy-makers that have ceded power for rule-making to standard setters are, at least in some jurisdictions, requesting greater evidence to demonstrate that the standard setter has taken into account the economic and behavioural consequences of the standards they are imposing on businesses. For example, the Trustees of the IFRS Foundation recently reviewed their governance arrangements as part of their ‘Constitution Review’ in order to respond to requests to make the international accounting standard setting process more transparent and accountable. Part 2 of the ‘Constitution Review’, issued in April 2010, states: “*The Trustees were of the opinion that the introduction of feedback statements, effect analyses and other improvements to the due process procedures in 2008 would also improve the IASB’s feedback and outreach activities.*”[12] The European Commission had

[12] International Accounting Standards Committee Foundation (IASCF) (2010), *Report of the IASC Foundation Trustees on Part 2 of their Constitution Review – Changes for Enhanced Public Accountability and Stakeholder Engagement*.

previously, in June 2009, stated that "*effects analyses should play a much more important role in the IASB's due process*"[13].

*Counter-argument:*
It could be argued that this objective can be achieved via governance arrangements or some other mechanism, such that effects analysis is not necessary (refer to paragraph 2.9).

b) *In response to the financial crisis:*
The 'Report of the Financial Crisis Advisory Group (FCAG)', dated 28 July 2009, states:

> *We firmly believe that improvements in accounting standards can help promote global financial stability and sound economic growth by enhancing transparency, reducing complexity and restoring confidence that the extent of losses in the financial system has been recognized and disclosed.*[14]

The global financial crisis sharpened interest in whether the standard setting process is effective in contributing positively to delivering improved financial reporting; it engendered a debate on the potential effects of accounting standards on financial stability. It may thus be argued that effects analysis should be integrated (or further embedded) into the standard setting due process as an appropriate response to the financial crisis, in that it will serve as a means for standard setters to demonstrate why and how their work contributes positively to improving the quality of financial reporting and thus results in more efficient and effective economic decision-making. As such, effects analysis will contribute to maintaining confidence in accounting standards and the existing financial reporting model.

*Counter-argument:*
The FCAG report acknowledges that:

> *All users should recognize the limitations of financial reporting: it provides only a snapshot in time of economic performance, and cannot provide perfect insight into the effects of macro-economic developments. …To develop standards that are high quality and unbiased, accounting standard setters must enjoy a high degree of independence from undue commercial and political pressures.*[15]

It may be argued that the existing remit of standard setters does not extend to considering the effects of accounting standards on financial stability, and that improved financial reporting would not have averted the financial crisis anyway, and this may (or may not) be sufficient for some to conclude that it is

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13 European Commission (2009), *Comment letter (CL68) of 22 June 2009, to the International Accounting Standards Committee Foundation (IASCF) in response to the discussion document 'Review of the Constitution – Identifying Issues for Part 2 of the Review'*.
14 Financial Crisis Advisory Group (FCAG) (2009), *Report of the Financial Crisis Advisory Group*.
15 Financial Crisis Advisory Group (FCAG) (2009), *Report of the Financial Crisis Advisory Group*.

not necessary to respond to the financial crisis by integrating (or further embedding) effects analysis into the standard setting due process.

c) *To enhance transparency, accountability and credibility:*
As explained in paragraph 2.8, the main aims of integrating (or further embedding) 'effects analysis' into the standard setting due process are to strengthen that process and enhance its transparency, to increase the accountability and credibility of the standard setter, and thus to contribute positively to delivering improved financial reporting. It may be argued that greater transparency, accountability and credibility is required for the reasons already discussed in 'a' and 'b', namely to respond to the requests of governments and other policy-makers, and in response to the financial crisis. Further arguments for greater transparency, accountability and credibility are as follows:

i) To address the criticism, and challenges to their credibility, that standard setters will inevitably sustain in mediating a path between the demand for information from users of the financial statements and the objections of the preparers who suffer the inconvenience of supplying that information, particularly where a proposed standard or amendment is disadvantageous for one party or the other;

ii) So that standard setters can demonstrate that they have considered the effects of accounting standards in making their decisions; this is particularly relevant for the IASB in view of the increasingly far-reaching consequences of its decisions across the globe as more jurisdictions converge to IFRSs; and

iii) So that standard setters have the evidence to respond to any other challenge, legal or otherwise, by any stakeholder, constituent or interested party.

*Counter-argument:*
It could be argued that this objective can be achieved via governance arrangements or some other mechanism, such that effects analysis is not necessary (refer to paragraph 2.9).

d) *To bring the standard setting process into line with other processes of regulation:*
Radaelli and Meuwese note that the recent European "*infatuation*" with the policy of 'Better Regulation' does not necessarily mean that such policies are "*novel ideas*", and they also note that "*procedures for administrative rule-making are well-known to countries such as the US, Canada, Australia and New Zealand*"[16]. A general view in many jurisdictions, including those referred to by Radaelli and Meuwese, is that regulators should attempt to assess the impact of their decisions. In the UK, for example, all regulators are required to carry out impact assessments, which are claimed to "*help*

[16] Radaelli, Claudio M. and Meuwese, Anne C. M. (2008) "Better Regulation in Europe: Between Public Management and Regulatory Reform", *Public Administration* (September 2009, Volume 87, Issue 3, p.639).

*policy makers to fully think through the reasons for government intervention, to weigh up various options for achieving an objective and to understand the consequences of a proposed intervention*"[17]. It may therefore be argued that standard setters should integrate (or further embed) effects analysis into their due process in order to bring standard setting into line with other processes of regulation and thus to emulate the good practices found there. Ball agrees:

> *The approach taken by standard setters should mirror that of public sector agencies that have an obligation to justify regulatory interventions. It means that those of us who set standards outside the public sector, but look to public sector endorsement in whatever form, should, to the best of our ability, strive to ensure that what we do* ***does*** *serve the public interest.*[18]

*Counter-argument:*
Robertson notes: "*The extent to which [impact assessments are] leading to improved outputs in terms of "better" proposals for legislation or regulation is still an open question…*"[19] Although processes of regulation other than standard setting already attempt to assess the effects of their decisions, studies find that there remains considerable variability in the quality of their impact assessments, and that it remains unclear how these assessments influence decision-making in a meaningful way[20]. It has also been found that, where these approaches to impact assessment have been applied to financial regulation, the resulting output is at best an act of compliance producing quantifications of costs but not benefits. It may thus be argued that effects analysis should not be integrated into the standard setting due process because it may not strengthen that process and could just slow it down, by becoming simply an administrative burden to satisfy a regulatory requirement. However, some argue that the aforementioned studies that give rise to this conclusion are restricted to a consideration of the documentary output of impact assessments and that these studies thus fail to take into account more important but less tangible benefits derived from applying an impact assessment or effects analysis, namely improved decision-making as a result of considering the effects of decisions throughout the decision-making process.

e) *To defend standard setters against assertions of being driven solely by theoretical conjecture:*
It is common for standard setters to state that a proposed accounting standard or amendment is likely to lead to an improvement in financial reporting, but it may be the perception of some that such a statement results simply from the standard setter's erudite view of what represents a

[17] Department for Business, Innovation and Skills (BIS) (2010), *Impact Assessment Guidance*.
[18] Ball, Ian (2006) "Overview of Fair Value Measurement Requirements in IFRSs" (2006), *United Nations Conference on Trade and Development Working Group of Experts on International Standards of Accounting and Reporting* (October 2006).
[19] Robertson, Craig (2008) "Impact Assessment in the European Union", *Eipascope* (September 2008, Special Issue 2008/2).
[20] For example, refer to: *Evaluation of Regulatory Impact Assessments 2006-07*, which was issued by the National Audit Office (NAO) on 11 July 2007.

'theoretically correct answer'. The CRUF, for example, has called upon the IASB to ensure that any future changes to standards are evidence-based:

> "*One of the key themes which we want to highlight is the need for "evidence-based" standard setting. We regard standard setting as very much a political endeavour in the broad sense of the word – in other words it should be a process of discussion and debate whereby the various stakeholders in the process (users, preparers, accountants, regulators and standard setters) determine principles-based but pragmatic solutions…*"[21]

Advocates of effects analysis might note that the utility of a theoretical solution to a financial reporting issue is dependent on its ability to be applied in practice. They would argue that accounting standards should result from a process that takes into account a broad evidence base that includes a consideration of, and consultation on, broad issues about the expected effects of accounting standards, including economic effects, commercial issues and even political considerations.

*Counter-argument:*
It could be argued that standard setters should be insulated from commercial and political considerations in order to be able to apply their professional skills to develop high quality standards without being influenced by such pressures. This issue is considered further, with regard to political considerations, in point 'c' of paragraph 3.15.

f) *So that standard setters are able to identify and correct problems:*
Effects analysis involves assessing the effects of accounting standards or amendments as they are developed, and it also entails a 'post-implementation review' (refer to paragraph 2.15). This enables the standard setter to quickly identify if there is a problem with a standard or amendment, and thus to take timely corrective action.

*Counter-argument:*
It could be argued that this objective can be achieved by some other mechanism, such that effects analysis is not necessary.

## C: Responsibility for performing effects analysis

2.11 The preliminary view is that the standard setter should be responsible for performing effects analysis, and that the performance of effects analysis by any other body is not a sufficient or satisfactory substitute.

2.12 It could instead be argued that, where the standard setter is a private sector body (for example, the IASB), considerations of costs, benefits and other effects should instead be the responsibility of securities regulators or other government agencies, given that these organisations represent a public policy interest. It

[21] Corporate Reporting User Forum (CRUF) (2008), *Letter of 5 June 2008, to Sir David Tweedie and Bob Hertz*.

could also be argued that effects analysis should be performed by a body other than the standard setter because the latter should not be influenced by commercial and political pressures in its development of high quality accounting standards. The issue of whether a standard setter should take into account macro-economic effects, which can include commercial and political pressures, is considered in paragraphs 3.11 to 3.15. In general, however, it might be noted that considering commercial and political effects, which may have been identified by constituents, is different from being unduly swayed by commercial and political considerations. Moreover, standard setters should be able to actively demonstrate that they have discharged their obligation to demonstrate that their activities are contributing positively to delivering improved financial reporting; many would argue that this is a fundamental part of discharging their accountability as standard setters.

2.13 If the standard setter does not perform the effects analysis, many of its benefits may not be fully realised, including the arguments ‘a’ to ‘f’ of paragraph 2.10 that are listed in favour of integrating (or further embedding) effects analysis into the standard setting due process. The party performing the effects analysis will not have produced the accounting standard or amendment and thus will be isolated from the issues encountered during the standard setting process. At present[22], for example, EFRAG carries out an effects study as part of the endorsement process for the adoption of IFRSs within the European Union, but such effects studies are performed only after the IASB has finalised the relevant accounting standard or amendment. This paper (refer to principle 4 of paragraph 4.2, and to paragraph 4.7) argues that effects should be considered throughout the standard setting process in order to enhance that process, and it is noted that effects analysis is not simply a document or a single point-in-time event (refer to paragraph 2.4). EFRAG’s effects studies cannot thus exhibit all attributes of effects analysis that are described in this paper, and therefore are not intended to be a substitute for an effects analysis performed by a standard setter.

## D: Frequency and timing of effects analysis

2.14 The IASB standard setting process comprises six stages, as follows:

1. Setting the agenda
2. Planning the project
3. Developing and publishing the discussion paper
4. Developing and publishing the exposure draft
5. Developing and publishing the standard
6. After the standard is issued

22 When EFRAG restructured its governance arrangements in 2008, it anticipated that it would increasingly rely on the effects analysis undertaken by the IASB.

2.15 The preliminary view is that effects should be considered throughout the life-cycle of a project to introduce a new accounting standard or amendment, but that publication of a document setting out the key elements of the effects analysis should be specifically required, as a minimum, at the following points in time in that life-cycle:

A. When an agenda proposal on the project is considered by the standard setter;

B. When a discussion paper is issued for public consultation (this effects analysis is an update to ‘A’, to reflect the latest information available);

C. When an exposure draft is issued for public consultation (this effects analysis is an update to ‘B’, to reflect the latest information available);

D. When a final standard or amendment is issued (this effects analysis is an update to ‘C’, to reflect the latest information available); and

E. For new accounting standards and major amendments, a ‘post-implementation review’ is required, which is an analysis of ‘actual effects’ that should be performed and published when the pronouncement has been applied for at least 2 years, together with the publication of an associated document setting out the key elements of the review; a post-implementation review is not required for minor amendments. (The terms ‘anticipated effects’ and ‘actual effects’ are considered further in paragraphs 3.28 and 3.29.)

2.16 As an accounting standard or amendment is implemented, anticipated effects are reassessed based on more up-to-date information and evidence; actual effects, in terms of the experience of preparers and users, may not be consistent with anticipated effects. The standard setting process, including the effects analysis, should reflect this, by being open, consultative, iterative and ongoing; effects analysis is not simply a document. On the other hand, it could be argued that this will just exacerbate the resource requirement that is created by the integration of effects analysis into the standard setting due process, to the point where these analyses become a bureaucratic and administrative burden. The preliminary view set out above is intended to strike the right balance.

2.17 A post-implementation review entails a consideration of ‘actual effects’ after the effective date of a pronouncement, whereas earlier effects analyses would have been more concerned with ‘anticipated effects’ during the development stage of a pronouncement. Arguments in favour of performing a post-implementation review are listed below. It should not be assumed that this is an exhaustive list.

a) The IASB, the international standard setter, has made a commitment to undertake post-implementation reviews of its major projects, and Alan Teixeira (Director of Technical Activities at the IASB) has noted that “*these reviews will provide an opportunity to assess how accurate our assertions have been*”[23].

[23] Teixeira, Alan (2010), *Agenda Paper for the Standards Advisory Council (SAC) Meeting of February 2010 – Effects Analysis*.

b) Having issued an accounting standard or amendment, the standard setter can use a post-implementation review to confirm that the standard or amendment has been successful in achieving its intended outcomes and in contributing positively to delivering improved financial reporting.

c) The 'Impact Assessment Guidance', issued by the UK BIS in November 2010, notes that: "*Government expects policymakers to evaluate policies after implementation because such evaluation can yield valuable insights. Examining the actual impact of policies can show what works, what could be improved, and how others can learn from the approaches used.*"[24]

d) A post-implementation review may lead to the identification of issues, problems, unintended consequences or possibilities for simplification, thus giving rise to further project work which aims to contribute positively to delivering improved financial reporting.

2.18 Post-implementation reviews are discussed further in paragraph 2.21.

## E: Proportionality in performing effects analysis

2.19 The preliminary view is that effects analysis should be undertaken for all[25] new accounting standards or amendments, but that the depth of the analysis work should be proportionate to the scale of the effects (in terms of their 'likelihood' of occurring and the magnitude of the 'consequences' if they do occur), the sensitivity of the proposals and the time available.

2.20 A less detailed effects analysis may be adequate where it is anticipated that a proposal will impact only a small number of preparers and users, or will have only a minor impact on a large number of preparers or users.

2.21 It should also be noted that the preliminary view set out in paragraph 2.15 includes the proposal that a post-implementation review will not be required for minor amendments. A post-implementation review is required for new accounting standards and major amendments, but the preliminary view set out in paragraph 2.19 means that it will in many cases be appropriate for that review to be more focussed in scope. It might be argued that the following statement from the 'Due Process Handbook for the IASB', concerning post-implementation reviews, is consistent with the preliminary views set out in paragraphs 2.15 and 2.19:

*[Post-implementation] reviews are normally limited to important issues identified as contentious during the development of the pronouncement and*

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24 Department for Business, Innovation and Skills (BIS) (2010), *Impact Assessment Guidance*.

25 This statement is not inconsistent with the preliminary view set out in 'E' of paragraph 2.15 of this paper, which does not require the performance or publication of a post-implementation review for minor amendments, as that same preliminary view does not make any exception for minor amendments when it requires effects analysis to be performed at the agenda proposal, discussion paper, exposure draft and final standard/ amendment stages. In accordance with the preliminary view set out in paragraph 2.19, however, the depth of the analysis work performed is likely to be lower for effects analysis that concerns a minor amendment.

*consideration of any unexpected costs or implementation problems encountered. The review may also be prompted by:*

- *changes in the financial reporting environment and regulatory requirements; and*

- *comments made by the SAC, the IFRIC, standard-setters and constituents about the quality of the IFRS.*[26]

## QUESTIONS FOR RESPONDENTS

1) Do you agree that 'effects analysis' should be defined, for the purposes of accounting standard setting, as 'a systematic process for considering the effects of accounting standards as those standards are developed and implemented' (paragraph 2.2)?

   If you disagree with the proposed definition, or would like it to be amended, please provide an alternative definition, and please explain why you favour that alternative definition.

2) Do you agree that effects analysis should be integrated (or further embedded) into the standard setting due process (paragraph 2.7)? If not, why not? Please explain the reasons for your answer.

3) Do you agree that the standard setter should be responsible for performing effects analysis, and that the performance of effects analysis by any other body is not a sufficient or satisfactory substitute (paragraph 2.11)? If not, why not? Please explain the reasons for your answer.

4) Do you agree that effects should be considered throughout the life-cycle of a project to introduce a new accounting standard or amendment, but that publication of a document setting out the key elements of the effects analysis should be specifically required, as a minimum, at the following points in time in that life-cycle (paragraph 2.15)?:

   A. When an agenda proposal on the project is considered by the standard setter;

   B. When a discussion paper is issued for public consultation (this effects analysis is an update to 'A', to reflect the latest information available);

   C. When an exposure draft is issued for public consultation (this effects analysis is an update to 'B', to reflect the latest information available);

   D. When a final standard or amendment is issued (this effects analysis is an update to 'C', to reflect the latest information available); and

[26] International Acccounting Standards Committee Foundation (IASCF) (2008), *Due Process Handbook for the IASB*.

E. For new accounting standards and major amendments, a ‘post-implementation review’ is required, which is an analysis of ‘actual effects’ that should be performed and published when the pronouncement has been applied for at least 2 years, together with the publication of an associated document setting out the key elements of the review; a post-implementation review is not required for minor amendments.

If you do not agree, why is this? Please explain the reasons for your answer.

5) Do you agree that effects analysis should be undertaken for all new accounting standards or amendments, but that the depth of the analysis work should be proportionate to the scale of the effects (in terms of their ‘likelihood’ of occurring and the magnitude of the ‘consequences’ if they do occur), the sensitivity of the proposals and the time available (paragraph 2.19)? If not, why not? Please explain the reasons for your answer.

## SECTION 3: The concept of 'effects'

### Introduction

3.1 This section explores the concept of 'effects'; it includes the following:

A. Definition of 'effects';

B. Comparing the term 'effects' to the term 'costs and benefits';

C. The scope of the 'effects' to be considered;

D. Reconciling the 'expectation gap' to the scope of the 'effects' to be considered;

E. Clarifying the definition of 'effects' – reference to an objective;

F. Clarifying the term 'effects'; and

G. Further considerations concerning effects.

### A: Definition of 'effects'

3.2 The term 'effects' can mean different things to different people. The preliminary view is that 'effects' should be defined, for the purposes of accounting standard setting, as 'consequences that flow, or are likely to flow, from an accounting standard, referenced against the objective of serving the public interest by contributing positively to delivering improved financial reporting'.

3.3 This paper primarily uses the term 'effects', but the terms 'impacts' and 'consequences' are considered to have a similar meaning.

3.4 Question 6, at the end of this section, asks the reader to comment on the above definition of 'effects' for the purposes of accounting standard setting. To assist the reader in considering this question, the UK BIS definition of 'impacts' and an accounting historian's definition of 'consequences' are provided below.

- The UK BIS definition of 'impacts' in the 'Impact Assessment Guidance', issued in November 2010:

  > *…the likely costs and benefits (monetised as far as possible) and the associated risks of a proposal that might have an impact on the public, private or civil society organisations...*[27]

- The definition of 'consequences' in the article 'The Rise of "Economic Consequences"', written by Stephen Zeff and published in December 1978:

[27] Department for Business, Innovation and Skills (BIS) (2010), *Impact Assessment Guidance*.

> *By "economic consequences" is meant the impact of accounting reports on the decision-making behavior of business, government, unions, investors and creditors. It is argued that the resulting behavior of these individuals and groups could be detrimental to the interests of other affected parties. And, the argument goes, accounting standard setters must take into consideration these allegedly detrimental consequences when deciding on accounting questions.*[28]

3.5 The reader should consider all of Section 3 prior to answering Question 6, or indeed any other question at the end of this section.

## B: Comparing the term 'effects' to the term 'costs and benefits'

3.6 It might be argued that the term 'costs and benefits', as it is used in the field of economics, has a similar or identical meaning to the term 'effects', as defined in paragraph 3.2. Examples of 'costs'[29], in the context of standard setting, are the cost of developing a standard, the cost of educating preparers, auditors and users, the cost of implementing system changes to support new requirements, the cost of auditing new information and systems, and the legal and competitive exposures that arise out of making new information available; examples of 'benefits'[30] are the benefit that an entity gains from an improved financial report, the benefit that a user gains from an improved flow of accounting information and so reduced information search costs, and the benefit that a preparer gains from obtaining an increased knowledge of the financial position and results of the organisation.

3.7 The term 'effects' has deliberately been used in this paper, instead of the term 'costs and benefits'. The term 'costs and benefits', particularly 'costs', is often associated with quantification, but this paper recognises that some 'effects' cannot be easily quantified, particularly (but not exclusively) many 'macro-economic effects' (refer to paragraph 3.14), so quantifiable 'costs and benefits' are thus a subset of all 'effects' as considered by this paper. Moreover, the term 'cost benefit analysis' is often associated with a requirement to quantify costs and benefits, so the preliminary view is that the term 'effects', rather than the term 'costs and benefits', should be used to refer to the consequences of accounting standards[31], in order to distinguish effects analysis from a quantified cost benefit analysis (CBA), on the grounds that it would not be appropriate to require a CBA to be applied to standard setting.

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28 Zeff, Stephen A. (1978) "The Rise of "Economic Consequences"", *The Journal of Accountancy* (December 1978, Volume 146, No. 6, p.56).

29 Financial Accounting Standards Advisory Council (1990) "Are Costs-Benefits Measurable?", *FASB Special Report – Benefits, Costs and Consequences of Financial Accounting Standards* (November 1991, p. 21).

30 Financial Accounting Standards Advisory Council (1990) "Are Costs-Benefits Measurable?", *FASB Special Report – Benefits, Costs and Consequences of Financial Accounting Standards* (November 1991, p. 21).

31 A consequential amendment to the IASB Conceptual Framework may arise from this preliminary view, so that it uses the term 'effects', rather than the term 'costs and benefits', to refer to the consequences of accounting standards.

3.8 It should be noted that it is not the intention of this paper to, in expressing a preference for the term ‘effects’ rather than the term ‘costs and benefits’, preclude the use of a CBA in relation to standard setting. It may, in certain circumstances where it is decision-useful and meaningful to do so (depending on the issue being considered), be appropriate to perform a quantitative assessment of costs and benefits as part of the process of completing effects analysis, but the preliminary view is that a CBA should not be a formal requirement for the purposes of standard setting; the emphasis should be on the robustness of the evidence (refer to principle 3 of paragraph 4.2, and also to paragraph 4.6).

3.9 Question 7, at the end of this section, asks the reader to comment on the preliminary view set out in paragraph 3.7. To assist the reader in considering this question, specific arguments for why it would not be appropriate to require a CBA to be applied to standard setting are set out in paragraph 3.10, together with a counter-argument.

3.10 Arguments for why it would not be appropriate to require a CBA to be applied to standard setting are listed below, together with a counter-argument. It should not be assumed that this is an exhaustive list.

a) *Difficult to apply to standard setting:*
There is a lack of sufficiently well-established and reliable techniques for quantifying the costs and benefits associated with a proposed accounting standard or amendment. Such costs and benefits are often intangible and qualitative in nature, so quantifying them is inherently subjective and complex, particularly so for the benefits. Furthermore, the costs and benefits are often not borne by the same party; the FASB notes that “*even if the costs and benefits are not traced beyond the preparers and users of information, to say anything precise about their incidence is difficult*”[32]. It might well be argued, therefore, that the application of a CBA to standard setting is often unworkable and impracticable, and that the resulting information is thus unlikely to be reliable. For example, it may be relatively difficult to assess the anticipated positive effects of a voluntary standard on management commentary beyond describing in qualitative terms the benefits from improving the way in which entities communicate to users about their performance and operating environment.

b) *Suitable for other areas of regulation, but not economic regulation:*
Economic regulation is different to environmental, health or safety regulation; for example, the former attempts to affect allocative efficiency whereas the latter is directed at alleviating the adverse consequences of market activities. It might therefore be argued that a CBA is not suitable for standard setting, even though it may be suitable for other areas of regulation.

c) *Costly to apply to standard setting:*

[32] Financial Accounting Standards Board (FASB) (2008), *Original Pronouncements As Amended – Statement of Financial Accounting Concepts No. 2 – Qualitative Characteristics of Accounting Information*.

Obtaining data to form a quantitative assessment of the costs and benefits of applying a proposed accounting standard or amendment is likely to be difficult and therefore costly to obtain, particularly in relation to benefits.

d) *Usefulness of the resulting information:*
Even if some form of CBA could be performed, it is not clear how that quantitative information would be applied to assist standard setters in making decisions concerning accounting standards. Standard setters should, in general, seek to serve the public interest, so it might be argued that public interest objectives should be the key decision criterion, not quantified cost benefit data. Effects can be qualitative and so are more suited to the nature of the standard setting process; they may be a more appropriate decision criterion in achieving the objective of serving the public interest by contributing positively to delivering improved financial reporting. It might be argued that a CBA is too binary, formulaic and reductionist in nature to be of any meaningful use for the purposes of standard setting, and that a decision concerning how to proceed with an accounting standard should not therefore be determined by whether a CBA calculates a net benefit or net loss.

e) *Misleading terminology:*
Schipper notes, in relation to the term 'costs and benefits', that "*it may make sense to abandon terminology that has perhaps been misleading, in the sense of non-descriptive of the cognitive processes standard setters actually follow*"[33] and that the terms "*effects*" or "*impacts*" might be more appropriate.

*Counter-argument:*
It could be argued that it would be appropriate to require a CBA to be applied to standard setting. This would require standard setters to find data, however uncertain that data and irrespective of how costly it is to obtain, to form a quantitative assessment of the costs and benefits of applying a given accounting standard or amendment. However, proponents of CBA might contend that claimed benefits are 'just claims' if they cannot be quantified, and that quantification is necessary in order to distinguish major costs and benefits from more minor ones.

## C: The scope of the 'effects' to be considered

3.11 The scope of the 'effects' to be considered may include:

a) All effects, both 'micro-economic effects' and 'macro-economic effects'[34]; or

[33] Schipper, Katherine (2009) "How Can We Measure the Costs and Benefits of Changes in Corporate Reporting Regulation?", *Information for Better Markets Conference* (December 2009).

[34] One way of analysing the universe of effects is by categorising them into the two sub-groups of 'micro-economic effects' and 'macro-economic effects'; an alternative way, which is not considered further in this paper, is to categorise them into the three sub-groups of 'primary economic effects on users and preparers' (for example, the cost of implementing a new accounting standard), secondary economic and behavioural effects on preparers, users and other stakeholders' (for example, changes in management behaviour) and 'tertiary economic and behavioural effects on markets and society as a whole' (for example, efficient capital markets).

b) A defined sub-group of all of the effects, perhaps 'micro-economic effects' only.

3.12 The preliminary view is that the scope of the 'effects' to be considered, for the purposes of performing effects analysis, should include all effects, both 'micro-economic effects' and 'macro-economic effects'.

3.13 Question 8, at the end of this section, asks the reader to comment on the scope of the 'effects' to be considered. To assist the reader in considering this question, the two main categories of effects, namely 'micro-economic effects' and 'macro-economic effects', are explained below. Specific arguments in favour of determining the scope of the 'effects' to be considered to include all effects (both 'micro-economic effects' and 'macro-economic effects') are set out in paragraph 3.15, together with their counter-arguments.

3.14 The two main categories of effects are described below.

- *Micro-economic effects:*
  Micro-economic effects are usually specific to the entity; they include those costs and benefits described in paragraph 3.6 which are specific to the entity, and economic behavioural impacts[35] that are specific to the entity. (A view different to the preliminary view described in paragraph 3.12, namely a view in favour of option 'b' of paragraph 3.11, might require 'specific to the entity' to be clearly defined.)

- *Macro-economic effects:*
  Macro-economic effects are not usually specific to the entity; they may go beyond the remit of contributing positively to delivering improved financial reporting, and they often relate to the entire economy. Macro-economic effects may be consequential effects, the so-called 'effects of effects'. Examples of macro-economic effects are financial stability impacts, more efficient allocation of resources, and redistributive effects within society. To understand how accounting standards can have such macro-economic effects, consider the case of a new accounting standard that requires the disclosure of information that was not previously available to the market. The availability of this information may change the way in which the user views the financial performance and position of some entities, thus impacting the cost of capital for those entities and giving rise to wealth transfers, which may result in the more efficient allocation of resources.

3.15 Arguments in favour of determining the scope of the 'effects' to be considered to include all effects (both 'micro-economic effects' and 'macro-economic effects') are listed below, together with their counter-arguments. It should not be assumed that this is an exhaustive list.

[35] At an Institute of Chartered Accountants of Scotland (ICAS) conference, on 4 September 2008, Sir David Tweedie said: "*Accounting, we are told, should not affect behaviour. I totally disagree. …accounting should reflect the economics – and that should drive behaviour.*"

a) *Standard setters work in the public interest:*
Standard setters should, in general, work in the public interest, and many act within an existing public policy framework. This would suggest that standard setters therefore have an accountability and transparency obligation to demonstrate that their activities are contributing positively to delivering improved financial reporting. However, it is difficult to see how standard setters can demonstrate this without assessing the consequences of their activities, and it would not be helpful for them to consider some effects and not others in forming their assessment.

*Counter-argument:*
It could be argued that consideration of effects beyond what is currently done will only serve to further bureaucratise the standard setting process and thus divert resources away from developing high quality accounting standards.

b) *Accounting standards are expected to have economic effects:*
Oscar Gellein, former member of the FASB, notes that "*at the highest level of purpose, financial reporting should be useful in bringing about efficient allocation of available resources*"[36]. Schipper adds to this by commenting that "*financial reporting should be one of the inputs used by investors and creditors in making decisions about where to invest and where to lend – it is a signal for capital allocation*"[37]. The IASB states, in referring to effects analysis in relation to its Business Combinations Phase II project, that:

> *One of the main objectives of developing a single set of high quality global accounting standards is to improve the allocation of capital. We therefore also consider the benefit of better economic decision-making as a result of improved financial reporting. We expect our standards to have economic effects...*[38]

Better economic decision-making as a result of an accounting standard or amendment is a macro-economic effect; the IASB comments suggest that it is not helpful to divorce macro-economic effects from micro-economic ones by considering only the latter.

*Counter-argument:*
Financial reports have limitations; for example, they provide only a snapshot in time of economic performance. Taking into account the limitations of financial reports, it could be argued that the impact that they have in terms of macro-economic effects is unlikely to be sufficient to warrant effort in assessing the macro-economic effects of accounting standards. It could also be argued that standard setters have no mandate to respond to macro-economic effects and that this is properly the role of governments within their

[36] Gellein, Oscar S., "Neutrality has Consequences" (1978), *FASB Special Report – Benefits, Costs and Consequences of Financial Accounting Standards* (November 1991, p.87).
[37] Schipper, Katherine (2009) "How Can We Measure the Costs and Benefits of Changes in Corporate Reporting Regulation?", *Information for Better Markets Conference* (December 2009).
[38] International Accounting Standards Board (IASB) (2008), *Business Combinations Phase II – Project summary, feedback and effects analysis*.

jurisdiction. Taking this one step further, it could be argued that to consider macro-economic effects would potentially undermine the neutrality of accounting standards and shift them into becoming instruments of economic and financial policy.

c) *Decisions may be influenced by political considerations:*
Decision-making is not formulaic and can sometimes be influenced by political considerations, which can hinder or prevent the implementation of a proposed accounting standard or amendment. Political considerations can thus have a critical impact on the ultimate utility of a proposed accounting standard or amendment. It might be argued, therefore, that standard setters should consider macro-economic effects, including political considerations, when performing effects analysis. If an accounting standard or amendment has been developed in this way, by considering broad issues about the expected effects of accounting standards, the standard setter has greater assurance that the implementation of their proposals will not be prevented or hindered by political considerations. The standard setter cannot otherwise assume that an accounting standard or amendment will be implemented successfully just because it faithfully represents the economic substance.

*Counter-argument:*
One counter-argument to the above is that it would, if taken to its extreme, result in accounting standards being determined by politicians rather than accountants, used as an instrument of public policy. It could be argued that standard setters should focus on the production of neutral information and should not be influenced by political considerations. Solomons describes this view as follows:

> *Accounting is financial mapmaking. The better the map, the more completely it represents the complex phenomena that are being mapped. We do not judge a map by the behavioural effects it produces… That should not be the concern of the cartographer. We judge his map by how well it represents facts. People can then react to it as they will.*[39]

Supporters of this view might also argue that standard setting sits uncomfortably with effects, which tend to be qualitative rather than quantitative, and which are often based on subjective judgements about what is likely to result from a new pronouncement. Furthermore, there is a view that the development of an accounting standard or amendment, and an analysis of the effects, should only extend as far as a consideration of the impact in terms of the conceptual framework, for example the IASB Conceptual Framework[40] and its qualitative characteristics (relevance, faithful representation, comparability, verifiability, timeliness and understandability), and thus it would be these principles which determine whether or not it is deemed to be likely that there will be an improvement in financial reporting.

[39] Solomons, David (1978) "The Politicization of Accounting", *The Journal of Accountancy* (November 1978, Volume 146, No. 5, p.65).

[40] International Accounting Standards Board (IASB) (2010), *Conceptual Framework for Financial Reporting 2010*.

## D: Reconciling the ‘expectation gap’ to the scope of the ‘effects’ to be considered

3.16 The preliminary view set out in paragraph 3.12 was that the scope of ‘effects’ to be considered, for the purposes of performing effects analysis, should include all effects, both ‘micro-economic effects’ and ‘macro-economic effects’. However, the quality of accounting standards is dependent on the independence of the standard setter, so a consideration of the effects of an accounting standard or amendment should not mean that a standard setter takes on a broader public policy role previously associated with other regulators and government bodies. There is perhaps a significant ‘expectation gap’ concerning what standard setters are able to do and what effects they are able or best placed to respond to, as highlighted by the arguably unwarranted criticism of standard setters following the emergence of the financial crisis. Schipper notes that “*standard setters may find it productive to clarify precisely what they are, and are not, able to do in terms of analyzing the effects of accounting standards*”[41]. On the other hand, it must be acknowledged that standard setters should not operate in isolation to the rest of financial regulation.

3.17 The preliminary view is that a standard setter can only be expected to respond to an effect which is outside of its remit (or for which an accounting standard is not the most effective means of addressing the particular effect) by communicating with the relevant regulator or government body to notify them of the relevant issue and to obtain confirmation from them that they will respond appropriately to it; it is then for the relevant regulator or government body to use the range of policy instruments at its disposal to intervene to ameliorate the economic consequences associated with the effect that has been identified.

## E: Clarifying the definition of ‘effects’ – reference to an objective

3.18 A working assumption of this paper is that standard setters, in general, seek to serve the public interest by contributing positively to delivering improved financial reporting (paragraph 3.2), and that this objective underlies any other appropriate objective of a standard setter. For example, the Preface to International Public Sector Accounting Standards states:

> *The objectives of the IPSASB [International Public Sector Accounting Standards Board] are to serve the public interest by developing high quality public sector financial reporting standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of financial reporting throughout the world.*[42]

Also, the four objectives of the IFRS Foundation can all be linked to the objective of ‘serving the public interest by contributing positively to delivering improved

[41] Schipper, Katherine (2009) “How Can We Measure the Costs and Benefits of Changes in Corporate Reporting Regulation?”, *Information for Better Markets Conference* (December 2009).

[42] International Public Sector Accounting Standards Board (IPSASB) (2007), *Preface to International Public Sector Accounting Standards*.

financial reporting'; objective 'a', in particular, is very closely aligned in that it states that an objective of the IFRS Foundation is:

> *…to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions.*[43]

3.19 The preliminary view set out in paragraph 3.2 was that 'effects' should be defined as 'consequences… …referenced against the objective of serving the public interest by contributing positively to delivering improved financial reporting'. It would, alternatively, have been possible to define 'effects' as consequences referenced to a different objective other than that of 'serving the public interest by contributing positively to delivering improved financial reporting', or as consequences not referenced to any objective at all. The preliminary view is that 'effects' should be defined by reference to an objective, and that the objective should be that of 'serving the public interest by contributing positively to delivering improved financial reporting', where 'serving the public interest' means 'taking into account the interests of investors, other participants in the world's capital markets and other users of financial information'. The phrase used here to define 'serving the public interest' is derived from the quote in paragraph 3.18 from the objectives of the IFRS Foundation. However, the notion of 'serving the public interest' is currently a subject of consultation by the International Federation of Accountants via its November 2010 Exposure Draft 'A Public Interest Framework for the Accountancy Profession'[44], so it will be revisited following the finalisation of that paper and following consultation on this paper.

3.20 Arguments for defining 'effects' as consequences referenced against an objective, any objective, are listed below. A discussion follows, in paragraphs 3.21 and 3.22, concerning what the objective should be.

- It is important to be clear about what it is that standard setters are attempting to achieve, as there may otherwise be confusion or a lack of common understanding concerning the role of the standard setter and 'what success looks like'. For example, confusion can arise because the objective of standard setting is sometimes conflated with the objective of financial reporting, which is a closely related but nevertheless different objective.

- Effects should be described by reference to an objective, as it will otherwise be unclear whether those effects are 'positive', 'negative' or 'neutral' effects. (The notion of 'positive', 'negative' and 'neutral' effects is considered further in paragraph 3.23.)

43 International Accounting Standards Committee Foundation (IASCF) (2010), *Constitution*.

44 International Federation of Accountants (IFAC) (2010), *A Public Interest Framework for the Accountancy Profession – Exposure Draft*.

- Effects should be assessed in terms of their impact on the achievement of an objective, as it will otherwise be unclear how the decisions taken by the standard setter maximise 'positive' effects and minimise 'negative' effects, and it will also be unclear how the evidence that the standard setter puts together will justify its decisions. (The notion of 'positive' and 'negative' effects is considered further in paragraph 3.23.)

3.21 It could be argued that 'effects' should be defined as consequences referenced against an objective other than that of 'serving the public interest by contributing positively to delivering improved financial reporting' (refer to the preliminary view set out in paragraph 3.19); for example, it could be suggested that the objective should not refer to 'serving the public interest', or that 'contributing positively to delivering improved financial reporting' should be replaced with 'contributing positively to delivering an improved allocation of resources' or 'contributing positively to increasing the decision usefulness of financial statements, described in terms of the qualitative characteristics of financial statements – relevance, faithful representation, comparability, verifiability, timeliness and understandability'. However, this paper contests that 'serving the public interest by contributing positively to delivering improved financial reporting' properly describes the purpose for which a standard setter exists and that any other objective is either not appropriate as an objective for a standard setter or is a subset of the objective of 'serving the public interest by contributing positively to delivering improved financial reporting'. An objective of 'contributing positively to delivering an improved allocation of resources', for example, might be considered not to be appropriate, on the basis that an improved allocation of resources is an outcome or effect of standard setting and not an objective of it.

3.22 As already indicated, it could also be argued that the meaning of 'serving the public interest' should be taken to be something other than 'taking into account the interests of investors, other participants in the world's capital markets and other users of financial information' (refer to the preliminary view set out in paragraph 3.19). For example, alternatives might be 'taking into account the interests of all users of the financial statements and other relevant stakeholders' or 'taking a broad view – considering the well-being of the community at large rather than just the perspective of a specific group of stakeholders'. *Readers may wish to comment on this in their response to this paper.*

## F: Clarifying the term 'effects'

*Positive, negative and neutral effects*

3.23 The preliminary view is that effects can be 'positive', 'negative' or 'neutral', as determined by whether they support, frustrate or have no impact on the achievement of the objective of serving the public interest by contributing positively to delivering improved financial reporting. (The objective of serving the public interest by contributing positively to delivering improved financial reporting was considered in paragraphs 3.18 to 3.22.)

*Marginal effects and absolute effects*

3.24 The preliminary view is that effects analysis will usually involve assessing the 'marginal effects' of an accounting standard or amendment, relative to the status quo that existed before its introduction, so the term 'effects' should, in general, be interpreted to refer to 'marginal effects'. It may, in rare instances, be appropriate to consider 'absolute effects' (the total effect), in which case this should be specifically clarified.

3.25 It is not usually possible or sensible to consider absolute effects; it is more feasible and useful to consider the marginal effects resulting from a new or amended financial reporting requirement. However, there may be rare instances where it is appropriate to consider absolute effects, for example if a package of significant new reporting requirement is being contemplated that prompts consideration of whether that package of requirements remains viable in terms of the overall effect on the financial report.

*One-off effects and ongoing effects*

3.26 The preliminary view is that the term 'effects' can be used to refer to both 'one-off effects' and 'ongoing effects'.

3.27 For example, 'one-off effects' would arise from the necessity of implementing system changes to support a proposed accounting standard or amendment; 'ongoing effects' would arise from reduced preparation costs as a result of a simplified requirement.

*Anticipated effects and actual effects*

3.28 The preliminary view is that the term 'effects' can be used to refer to both 'anticipated effects' and 'actual effects', depending on what stage the effects analysis is at – before, during or after implementation of the new accounting standard or amendment. (The frequency and timing of effects analysis was considered in paragraphs 2.15 and 2.16.)

3.29 Alan Teixeira (Director of Technical Activities at the IASB) has commented that:

> *The actual effects will not be known until after the new requirements have been applied. Our assertions of likely effects are based on the information that we collect during the development of the Standard. For example, we discuss implementation costs with entities, auditors and software vendors.*[45]

[45] Teixeira, Alan (2010), *Agenda Paper for the Standards Advisory Council (SAC) Meeting of February 2010 – Effects Analysis*.

## G: Further considerations concerning effects

*Incidence and nature of effects*

3.30 The preliminary view is that effects analysis should involve considering effects in terms of both their 'incidence' (who is affected) and their 'nature' (how they are affected), and that the standard setter should be transparent about whether and why they consider that the effects on one group should receive greater weight, less weight or equal weight to the effects on any other group.

3.31 Effects may have different impacts on different groups. For example, it could be argued that a new accounting requirement has negative effects for preparers but positive effects for users. It might also be noted that preparers often have a comparative advantage in developing information relative to the costs that users would incur to develop surrogate information; surrogate information may also be less reliable.

*Prioritising effects (likelihood and consequences)*

3.32 The preliminary view is that effects analysis should involve prioritising effects, possibly by 'ranking' them in terms of their 'likelihood' of occurring and the magnitude of the 'consequences' if they do occur.[46] (Note that, for actual effects assessed as part of a post-implementation review, the 'likelihood' will be one of certainty, by default.)

3.33 This should provide transparency concerning the decisions of the standard setter in responding to effects.

## QUESTIONS FOR RESPONDENTS

6) Do you agree that 'effects' should be defined, for the purposes of accounting standard setting, as 'consequences that flow, or are likely to flow, from an accounting standard, referenced against the objective of

[46] The standard setter may assign ratings for the 'likelihood' and 'consequences' of each effect on a five point scale, supported by a documented rationale to justify their judgements for each rating, then these ratings may be used to 'rank' each effect in accordance with the following table (or an adapted version of it):

| | **Consequences** | | | | |
|---|---|---|---|---|---|
| **Likelihood** | EXTREME | HIGH | MEDIUM | LOW | NEGLIGIBLE |
| ALMOST CERTAIN | Severe | Severe | High | Major | Significant |
| LIKELY | Severe | High | Major | Significant | Moderate |
| MODERATE | High | Major | Significant | Moderate | Low |
| UNLIKELY | Major | Significant | Moderate | Low | Trivial |
| RARE | Significant | Moderate | Low | Trivial | Trivial |
| *Source:* Government of Western Australia (1999), *Guidelines for Managing Risk in the Western Australian Public Sector*. | | | | | |

serving the public interest by contributing positively to delivering improved financial reporting' (paragraph 3.2)?

If you disagree with the proposed definition, or would like it to be amended, please provide an alternative definition and please explain why you favour that alternative definition.

7) Do you agree that the term 'effects', rather than the term 'costs and benefits', should be used to refer to the consequences of accounting standards, in order to distinguish effects analysis from a CBA, on the grounds that it would not be appropriate to require a CBA to be applied to standard setting (paragraph 3.7)? If not, why not? Please explain the reasons for your answer.

8) Do you agree that the scope of the 'effects' to be considered, for the purposes of performing effects analysis, should include all effects, both 'micro-economic effects' and 'macro-economic effects' (paragraph 3.12)?

If you disagree, please provide an alternative way of specifying what the scope of the 'effects' to be considered should be, and please explain why you favour that alternative.

9) Do you agree that a standard setter can only be expected to respond to an effect which is outside of its remit (or for which an accounting standard is not the most effective means of addressing the particular effect) by communicating with the relevant regulator or government body to notify them of the relevant issue and to obtain confirmation from them that they will respond appropriately to it (paragraph 3.17)? If not, why not? Please explain the reasons for your answer.

10) Do you agree that 'effects' should be defined by reference to an objective, and that the objective should be that of 'serving the public interest by contributing positively to delivering improved financial reporting', where 'serving the public interest' means 'taking into account the interests of investors, other participants in the world's capital markets and other users of financial information' (paragraph 3.19)?

If you disagree because you consider that 'effects' should not be defined by reference to an objective, please explain the reasons for your answer.

If you disagree because you consider that 'effects' should be defined by reference to an objective other than that specified above, please provide an alternative objective and please explain why you favour that alternative objective.

11) Do you agree with the following clarifications of the term 'effects'?:

a) Effects can be 'positive', 'negative' or 'neutral', as determined by whether they support, frustrate or have no impact on the achievement of the objective of serving the public interest by contributing positively to delivering improved financial reporting (paragraph 3.23);

b) Effects analysis will usually involve assessing the 'marginal effects' of an accounting standard or amendment, relative to the status quo that existed before its introduction, so the term 'effects' should, in general, be interpreted to refer to 'marginal effects' (paragraph 3.24);

c) The term 'effects' can be used to refer to both 'one-off effects' and 'ongoing effects' (paragraph 3.26); and

d) The term 'effects' can be used to refer to both 'anticipated effects' and 'actual effects', depending on what stage the effects analysis is at – before, during or after implementation of the new accounting standard or amendment (paragraph 3.28).

If you do not agree with any of the above clarifications of the term 'effects', which one(s) do you disagree with and why? Please explain the reasons for your answer.

12) Do you agree with the following further considerations concerning effects:

a) Effects analysis should involve considering effects in terms of both their 'incidence' (who is affected) and their 'nature' (how they are affected), and that the standard setter should be transparent about whether and why they consider that the effects on one group should receive greater weight, less weight or equal weight to the effects on any other group (paragraph 3.30); and

b) Effects analysis should involve prioritising effects, possibly by 'ranking' them in terms of their 'likelihood' of occurring and the magnitude of the 'consequences' if they do occur (paragraph 3.32).

If you do not agree with any of the above further considerations concerning effects, which one(s) do you disagree with and why? Please explain the reasons for your answer.

## SECTION 4: The key principles underpinning effects analysis

### Introduction

4.1 This section considers whether there should be a set of key principles underpinning effects analysis, and what those principles should be; it includes the following:

A. Determining the key principles; and

B. Further considerations concerning the key principles.

### A: Determining the key principles

4.2 The provision of a set of key principles underpinning effects analysis is intended to provide the foundation for a more systematic process for considering the effects of accounting standards as those standards are developed and implemented. The preliminary view is that there should be a set of key principles underpinning effects analysis, and that those principles should be as follows:

> ***Principle 1:*** *Explain intended outcomes*
> Standard setters should explain the intended outcomes of a proposed accounting standard or amendment in terms of their objective of serving the public interest by contributing positively to delivering improved financial reporting. This should be done at the agenda-setting stage;
>
> ***Principle 2:*** *Encourage input on anticipated effects*
> Constituents should be actively encouraged to provide input on anticipated effects, which should be considered against the standard setter's objective;
>
> ***Principle 3:*** *Gather evidence*
> The evidence gathered should demonstrate that the proposals faithfully represent the underlying economic reality and produce information that has utility for users. Effects should be quantified where such quantification is practicable and is likely to be useful to decision-making; and
>
> ***Principle 4:*** *Consider effects throughout the due process*
> Consideration of the effects of an accounting standard or amendment should occur throughout the standard setting process; it should be embedded in that process and not considered as a single event.

4.3 Further considerations concerning the above key principles are detailed in paragraphs 4.4 to 4.7.

## B: Further considerations concerning the key principles

4.4 Principle 1 ensures that preparers, users and other constituents have a common understanding concerning the intended outcomes of the specific problem or issue that the standard setter aims to address by introducing a proposed accounting standard or amendment, as well as how those intended outcomes are aligned to the overall objective of the standard setter and thus are in the 'public interest'.

4.5 Principle 2 requires standard setters to consult with constituents concerning the anticipated effects of a proposed accounting standard or amendment, in recognition of the fact that some constituents may be aware of effects that the standard setter is not. Responses from constituents are then considered against the standard setter's objective of serving the public interest by contributing positively to delivering improved financial reporting, thus avoiding a fruitless attempt to reflect the entire universe of potential effects, and because constituents may sometimes make partisan assertions in the responses that they provide. From a transparency perspective, the process of systematically consulting constituents (as well as considering any other research or outreach activity concerning the effects of an accounting standard or amendment), identifying claimed effects and setting out a response to those effects is an important part of the standard setter's due process. The preliminary view (paragraph 5.5) is that the IASB should, to some degree, delegate to national standard setters and similar institutions some of the activities involved in applying this consultation process.

4.6 Principle 3 refers to the expectation that standard setters put together a comprehensive body of robust evidence to inform and support their decisions concerning a proposed accounting standard or amendment, thus enhancing the transparency of the standard setting process and increasing the accountability of standard setters. Standard setters are expected to consider carefully, at each stage of the standard setting process, what evidence is required to assess effects and inform the development of the proposed accounting standard or amendment. Standard setters will also need to consider how that evidence can best be gathered and the extent to which constituents can be positively engaged in the evidence gathering process. The sentence of principle 3 that refers to the 'quantification' of effects is to be interpreted in the spirit of what is set out in paragraphs 3.7 to 3.10.

4.7 Principle 4 encourages standard setters to consider, at each stage of the standard setting process, the anticipated and actual effects of an accounting standard or amendment. It could be argued that standard setters already do this, informally, but the performance of effects analysis will ensure that there is an explicit and formal communicable record of the routine assessment of effects, thus enhancing the transparency of the standard setting process. It is, of course, important to ensure that effects analysis does not become a bureaucratic and administrative burden, but the preliminary view communicated in paragraph 2.15 is intended to strike the right balance. Moreover, effects analysis is not merely a document and, as noted by principle 4, is 'not considered as a single event'.

## QUESTIONS FOR RESPONDENTS

13) Do you agree that there should be a set of key principles underpinning effects analysis (paragraph 4.2)? If not, why not? Please explain the reasons for your answer.

14) Do you agree that the set of key principles underpinning effects analysis should be as follows (paragraph 4.2)?:

***Principle 1:*** *Explain intended outcomes* (refer to paragraph 4.2);

***Principle 2:*** *Encourage input on anticipated effects* (refer to paragraph 4.2);

***Principle 3:*** *Gather evidence* (refer to paragraph 4.2); and

***Principle 4:*** *Consider effects throughout the due process* (refer to paragraph 4.2).

If you disagree with the proposed set of key principles, or would like the principles to be amended, please provide an alternative set of key principles and please explain why you favour that alternative set.

## SECTION 5: The practicalities of performing effects analysis

### Introduction

5.1 This section considers the practicalities of performing effects analysis; it includes the following:

A. Validating intended outcomes;

B. Identifying and assessing effects;

C. Identifying options and choosing the preferred option; and

D. Collaboration with national standard setters and similar institutions.

### A: Validating intended outcomes

5.2 The preliminary view is that the process that a standard setter should apply for validating the intended outcomes of a proposed accounting standard or amendment should include the steps listed below.

a) The standard setter should review current accounting practice for the area to which the proposed accounting standard or amendment relates, including the perceived theoretical and practical advantages/ disadvantages of current practice.

b) The standard setter should confirm that there is an issue with current accounting practice or an opportunity to improve it, and that the net benefit of doing nothing is outweighed by the net benefit of issuing a new accounting standard or amendment. The standard setter should consider:

- The pervasiveness of the issue or the potential significance of the missed opportunity; in particular, the extent to which it is troublesome or disadvantageous to users, preparers and other constituents;

- The likely duration of the issue or missed opportunity; in particular, whether it is transitory or likely to persist;

- The extent to which there is diversity in the current accounting treatment; and

- What costs the status quo imposes.

c) In accordance with principle 1 of paragraph 4.2, the standard setter should explain the intended outcomes of the proposed accounting standard or amendment in terms of its objective of serving the public interest by contributing positively to delivering improved financial reporting.

d) The provisional analysis performed by the standard setter is subsequently exposed for public consultation, so that preparers, users and other constituents can validate or propose amendments to the assumptions that the standard setter made.

## B: Identifying and assessing effects

5.3 The preliminary view is that the process that a standard setter should apply for identifying and assessing the effects of a proposed accounting standard or amendment should include the steps listed below.

a) The standard setter should complete initial research in order to identify effects. This preliminary research may include some or all of the following:

- Consideration of previous projects and amendments in the same area to which the proposed accounting standard or amendment relates;
- Consideration of the qualitative characteristics of financial statements (relevance, faithful representation, comparability, verifiability, timeliness and understandability);
- Consideration of the elements of financial statements (assets, liabilities, income, expenses and equity);
- The use of relevant models for identifying effects[47];
- Initial informal consultation with preparers, users and other constituents (for example, round-table discussions); and
- The use of judgement by the standard setter.

b) The standard setter should split the effects into the following categories (as appropriate), in order to facilitate their assessment and communication:

- Positive, negative and neutral effects (refer to paragraph 3.23);
- Marginal effects and absolute effects (refer to paragraphs 3.24 and 3.25);
- One-off effects and ongoing effects (refer to paragraphs 3.26 and 3.27); and
- Anticipated effects and actual effects (refer to paragraphs 3.28 and 3.29).

c) The standard setter should apply its judgement to identify the ‘incidence’ and ‘nature’ of the effects (refer to paragraphs 3.30 and 3.31).

[47] Examples of relevant models are scenario planning or a ‘PEST analysis’, the latter of which involves a consideration of political, economic, social and technological environmental factors.

d) The standard setter should apply its judgement to prioritise the effects, possibly by 'ranking' them in terms of their 'likelihood' of occurring and the magnitude of the 'consequences' if they do occur (refer to paragraphs 3.32 and 3.33).

e) The provisional analysis performed by the standard setter is subsequently exposed for public consultation, so that preparers, users and other constituents can validate or propose amendments to the assumptions that the standard setter made.

f) Identifying and assessing effects is inherently difficult and judgmental, so standard setters should, in general, apply a routine and transparent process for identifying and assessing effects, which should be supported by robust evidence gathering, including engaging with constituents and responding to their views concerning effects. Refer to the preliminary view (paragraph 4.2) concerning the principles of effects analysis.

## C: Identifying options and choosing the preferred option

5.4 The preliminary view is that the process that a standard setter should apply for identifying options for the proposed accounting standard or amendment (options for achieving the intended outcomes of the proposed accounting standard or amendment), and for choosing the preferred option, should include the steps listed below.

a) The research, evidence gathering and consultation activity referred to in paragraph 5.3 should enable the standard setter to explore and clearly identify a number of feasible options for achieving the intended outcomes of the proposed accounting standard or amendment. One of the options that the standard setter considers should be the status quo option.

b) For each identified option, the standard setter should identify the 'effect adjustors', which are the measures, tests, consultation, research and other steps or aspects that the standard setter proposes to put in place to:

- Decrease the likelihood that the negative effects will frustrate the successful achievement of the intended outcomes of the proposed accounting standard or amendment; and

- Increase the likelihood that the positive effects will support the successful achievement of the intended outcomes of the proposed accounting standard or amendment.

An effect adjustor is often an action which the standard setter is to implement, but it should be noted that an effect adjustor can be an action for the standard setter to communicate with a relevant regulator or government body to notify them of the relevant issue and to obtain confirmation from them that they will respond appropriately to it (refer to paragraphs 3.16 to 3.17).

c) For each identified option, the standard setter should apply its judgement to prioritise the effects, possibly by 'ranking' them in terms of their 'residual likelihood' of occurring and the magnitude of the 'residual consequences' if they do occur (refer to paragraphs 3.32 and 3.33). The 'residual likelihood' and 'residual consequences' are, respectively, the 'likelihood' and 'consequences' (refer to 'd' in paragraph 5.3) once they have been modified to take into account the specific option under consideration and the effect adjustors that the standard setter proposes to put in place for that option.[48]

d) The standard setter should, at a very simplistic and theoretical level, select its preferred option to be the one which gives rise to the greatest number of higher-prioritised positive effects and the lowest number of higher-prioritised negative effects (whilst also taking into account lower-prioritised effects where they, in aggregate, give rise to a higher-prioritised effect). In practice, however, the standard setter should also consider the matters listed below in determining its preferred option. It should not be assumed that this is an exhaustive list.

- The incidence and nature of the higher-prioritised positive and negative effects (refer to paragraphs 3.30 and 3.31).

- The adequacy, for each identified option, of the evidence gathered about the effects and their prioritisation.

- Whether there is a cost-effective alternative option which is less costly but only slightly less effective.

- The standard setter objective of serving the public interest by contributing positively to delivering improved financial reporting.

The standard setter should clearly document which option is preferred, and why. A deeper analysis of the effects, effect adjustors and prioritisations should then be performed for this preferred option.

e) The provisional analysis performed by the standard setter is subsequently exposed for public consultation, so that preparers, users and other constituents can validate or propose amendments to the assumptions that the standard setter made.

f) Identifying and assessing options is inherently difficult and judgmental, so standard setters should, in general, apply a routine and transparent process for identifying and assessing options, which should be supported by robust evidence gathering, including engaging with constituents and responding to their views concerning options. Refer to the preliminary view (paragraph 4.2) concerning the principles of effects analysis.

[48] The 'likelihood' and 'consequences' prior to modification to take into account the effect adjustors may be termed, respectively, the 'inherent likelihood' and the 'inherent consequences'.

## D: Collaboration with national standard setters and similar institutions

5.5 The IASB may, given that it is an international standard setter, find it difficult to perform a comprehensive effects analysis which takes into account all jurisdictional-specific issues across multiple jurisdictions. The preliminary view is that the IASB should, to some degree, delegate to national standard setters and similar institutions some of the activities involved in gathering evidence of the effects of accounting standards, particularly consultation with constituents, and that these bodies should play a more active part in the due process to ensure that IFRSs contribute positively to delivering improved financial reporting.

### QUESTIONS FOR RESPONDENTS

15) Do you agree that the process that a standard setter should apply for validating the intended outcomes of a proposed accounting standard or amendment should include steps 'a' to 'd' of paragraph 5.2?

    If you disagree with the proposed steps, or would like the steps to be amended, please provide alternative steps and please explain why you favour those alternative steps.

16) Do you agree that the process that a standard setter should apply for identifying and assessing the effects of a proposed accounting standard or amendment should include steps 'a' to 'f' of paragraph 5.3?

    If you disagree with the proposed steps, or would like the steps to be amended, please provide alternative steps and please explain why you favour those alternative steps.

17) Do you agree that the process that a standard setter should apply for identifying options for the proposed accounting standard or amendment (options for achieving the intended outcomes of the proposed accounting standard or amendment), and for choosing the preferred option, should include steps 'a' to 'f' of paragraph 5.4?

    If you disagree with the proposed steps, or would like the steps to be amended, please provide alternative steps and please explain why you favour those alternative steps.

18) Do you agree that the IASB should, to some degree, delegate to national standard setters and similar institutions some of the activities involved in gathering evidence of the effects of accounting standards, particularly consultation with constituents, and that these bodies should play a more active part in the due process to ensure that IFRSs contribute positively to delivering improved financial reporting (paragraph 5.5)?

## SECTION 6:  Next steps

### Introduction

6.1 This section contemplates what should be the next steps in developing and, subject to the results of public consultation, implementing the proposals put forward in this paper.

### Progressing the proposals

6.2 The preliminary view is that the next steps in developing and, subject to the results of public consultation, implementing the proposals put forward in this paper should include the following:

a) Field testing of the proposals in the development of IFRSs via a 'live' IASB project; and

b) National standard setters and similar institutions should be encouraged to:

- Share their knowledge where elements of the proposals have already been implemented within their jurisdiction; and

- Partner with the UK ASB (Accounting Standards Board) and EFRAG staff in taking the proposals forward.

### QUESTION FOR RESPONDENTS

19) Do you agree that the next steps in developing and, subject to the results of public consultation, implementing the proposals put forward in this paper should include steps 'a' and 'b' of paragraph 6.2?

If you disagree with the proposed next steps, or would like there to be additional next steps, please provide alternative and/ or additional steps and please explain why you consider that those alternative and/ or additional next steps are appropriate.

## APPENDIX: Summary of questions for respondents

This appendix summarises all of the questions for respondents that are included in this paper.

### *SECTION 2: The process of 'effects analysis'*

1) Do you agree that 'effects analysis' should be defined, for the purposes of accounting standard setting, as 'a systematic process for considering the effects of accounting standards as those standards are developed and implemented' (paragraph 2.2)?

   If you disagree with the proposed definition, or would like it to be amended, please provide an alternative definition, and please explain why you favour that alternative definition.

2) Do you agree that effects analysis should be integrated (or further embedded) into the standard setting due process (paragraph 2.7)? If not, why not? Please explain the reasons for your answer.

3) Do you agree that the standard setter should be responsible for performing effects analysis, and that the performance of effects analysis by any other body is not a sufficient or satisfactory substitute (paragraph 2.11)? If not, why not? Please explain the reasons for your answer.

4) Do you agree that effects should be considered throughout the life-cycle of a project to introduce a new accounting standard or amendment, but that publication of a document setting out the key elements of the effects analysis should be specifically required, as a minimum, at the following points in time in that life-cycle (paragraph 2.15)?:

   A. When an agenda proposal on the project is considered by the standard setter;

   B. When a discussion paper is issued for public consultation (this effects analysis is an update to 'A', to reflect the latest information available);

   C. When an exposure draft is issued for public consultation (this effects analysis is an update to 'B', to reflect the latest information available);

   D. When a final standard or amendment is issued (this effects analysis is an update to 'C', to reflect the latest information available); and

   E. For new accounting standards and major amendments, a 'post-implementation review' is required, which is an analysis of 'actual effects' that should be performed and published when the pronouncement has been applied for at least 2 years, together with the publication of an associated document setting out the key elements of the review; a post-implementation review is not required for minor amendments.

If you do not agree, why is this? Please explain the reasons for your answer.

5) Do you agree that effects analysis should be undertaken for all new accounting standards or amendments, but that the depth of the analysis work should be proportionate to the scale of the effects (in terms of their 'likelihood' of occurring and the magnitude of the 'consequences' if they do occur), the sensitivity of the proposals and the time available (paragraph 2.19)? If not, why not? Please explain the reasons for your answer.

### *SECTION 3: The concept of 'effects'*

6) Do you agree that 'effects' should be defined, for the purposes of accounting standard setting, as 'consequences that flow, or are likely to flow, from an accounting standard, referenced against the objective of serving the public interest by contributing positively to delivering improved financial reporting' (paragraph 3.2)?

If you disagree with the proposed definition, or would like it to be amended, please provide an alternative definition and please explain why you favour that alternative definition.

7) Do you agree that the term 'effects', rather than the term 'costs and benefits', should be used to refer to the consequences of accounting standards, in order to distinguish effects analysis from a CBA, on the grounds that it would not be appropriate to require a CBA to be applied to standard setting (paragraph 3.7)? If not, why not? Please explain the reasons for your answer.

8) Do you agree that the scope of the 'effects' to be considered, for the purposes of performing effects analysis, should include all effects, both 'micro-economic effects' and 'macro-economic effects' (paragraph 3.12)?

If you disagree, please provide an alternative way of specifying what the scope of the 'effects' to be considered should be, and please explain why you favour that alternative.

9) Do you agree that a standard setter can only be expected to respond to an effect which is outside of its remit (or for which an accounting standard is not the most effective means of addressing the particular effect) by communicating with the relevant regulator or government body to notify them of the relevant issue and to obtain confirmation from them that they will respond appropriately to it (paragraph 3.17)? If not, why not? Please explain the reasons for your answer.

10) Do you agree that ‘effects’ should be defined by reference to an objective, and that the objective should be that of ‘serving the public interest by contributing positively to delivering improved financial reporting’, where ‘serving the public interest’ means ‘taking into account the interests of investors, other participants in the world’s capital markets and other users of financial information’ (paragraph 3.19)?

If you disagree because you consider that ‘effects’ should not be defined by reference to an objective, please explain the reasons for your answer.

If you disagree because you consider that ‘effects’ should be defined by reference to an objective other than that specified above, please provide an alternative objective and please explain why you favour that alternative objective.

11) Do you agree with the following clarifications of the term ‘effects’?:

a) Effects can be ‘positive’, ‘negative’ or ‘neutral’, as determined by whether they support, frustrate or have no impact on the achievement of the objective of serving the public interest by contributing positively to delivering improved financial reporting (paragraph 3.23);

b) Effects analysis will usually involve assessing the ‘marginal effects’ of an accounting standard or amendment, relative to the status quo that existed before its introduction, so the term ‘effects’ should, in general, be interpreted to refer to ‘marginal effects’ (paragraph 3.24);

c) The term ‘effects’ can be used to refer to both ‘one-off effects’ and ‘ongoing effects’ (paragraph 3.26); and

d) The term ‘effects’ can be used to refer to both ‘anticipated effects’ and ‘actual effects’, depending on what stage the effects analysis is at – before, during or after implementation of the new accounting standard or amendment (paragraph 3.28).

If you do not agree with any of the above clarifications of the term ‘effects’, which one(s) do you disagree with and why? Please explain the reasons for your answer.

12) Do you agree with the following further considerations concerning effects:

a) Effects analysis should involve considering effects in terms of both their ‘incidence’ (who is affected) and their ‘nature’ (how they are affected), and that the standard setter should be transparent about whether and why they consider that the effects on one group should receive greater weight, less weight or equal weight to the effects on any other group (paragraph 3.30); and

b) Effects analysis should involve prioritising effects, possibly by 'ranking' them in terms of their 'likelihood' of occurring and the magnitude of the 'consequences' if they do occur (paragraph 3.32).

If you do not agree with any of the above further considerations concerning effects, which one(s) do you disagree with and why? Please explain the reasons for your answer.

### *SECTION 4: The key principles underpinning effects analysis*

13) Do you agree that there should be a set of key principles underpinning effects analysis (paragraph 4.2)? If not, why not? Please explain the reasons for your answer.

14) Do you agree that the set of key principles underpinning effects analysis should be as follows (paragraph 4.2)?:

***Principle 1:*** *Explain intended outcomes* (refer to paragraph 4.2);

***Principle 2:*** *Encourage input on anticipated effects* (refer to paragraph 4.2);

***Principle 3:*** *Gather evidence* (refer to paragraph 4.2); and

***Principle 4:*** *Consider effects throughout the due process* (refer to paragraph 4.2).

If you disagree with the proposed set of key principles, or would like the principles to be amended, please provide an alternative set of key principles and please explain why you favour that alternative set.

### *SECTION 5: The practicalities of performing effects analysis*

15) Do you agree that the process that a standard setter should apply for validating the intended outcomes of a proposed accounting standard or amendment should include steps 'a' to 'd' of paragraph 5.2?

If you disagree with the proposed steps, or would like the steps to be amended, please provide alternative steps and please explain why you favour those alternative steps.

16) Do you agree that the process that a standard setter should apply for identifying and assessing the effects of a proposed accounting standard or amendment should include steps 'a' to 'f' of paragraph 5.3?

If you disagree with the proposed steps, or would like the steps to be amended, please provide alternative steps and please explain why you favour those alternative steps.

17) Do you agree that the process that a standard setter should apply for identifying options for the proposed accounting standard or amendment (options for achieving the intended outcomes of the proposed accounting standard or amendment), and for choosing the preferred option, should include steps ‘a’ to ‘f’ of paragraph 5.4?

If you disagree with the proposed steps, or would like the steps to be amended, please provide alternative steps and please explain why you favour those alternative steps.

18) Do you agree that the IASB should, to some degree, delegate to national standard setters and similar institutions some of the activities involved in gathering evidence of the effects of accounting standards, particularly consultation with constituents, and that these bodies should play a more active part in the due process to ensure that IFRSs contribute positively to delivering improved financial reporting (paragraph 5.5)?

### *SECTION 6: Next steps*

19) Do you agree that the next steps in developing and, subject to the results of public consultation, implementing the proposals put forward in this paper should include steps ‘a’ and ‘b’ of paragraph 6.2?

If you disagree with the proposed next steps, or would like there to be additional next steps, please provide alternative and/ or additional steps and please explain why you consider that those alternative and/ or additional next steps are appropriate.

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## ACKNOWLEDGEMENTS

*This paper has been prepared jointly by the staff of the UK standard setter, the Accounting Standards Board (ASB), and the staff of the European Financial Reporting Advisory Group (EFRAG), as part of Europe's proactive work in financial reporting. The lead author of the paper is Grant Chatterton (a Project Director at the ASB), with significant contributions and oversight provided by Mario Abela (EFRAG Director of Research) and David Loweth (ASB Technical Director).*