



**International Federation of Accountants**

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# **Agenda Item**

# **3**

**Committee:** IAASB

**Meeting Location:** Lisbon

**Meeting Date:** June 15-18, 2009

## **Impact Analysis**

### **Objective of Agenda Item**

1. The objectives of this agenda item are:
  - (a) To review and approve the proposed guidance on developing an Impact Analysis; and
  - (b) To agree on testing the practical application of the proposed analysis.

### **Task Force**

2. The Task Force comprises the following members:
  - John Fogarty (task force chair and IAASB member)
  - Wolf Boehm (IAASB technical advisor)
  - Jon Grant (IAASB member)
  - Steen Jensen (IAASB public member)
  - Bill Kinney (IAASB member)
  - Jon Rowden (IAASB technical advisor)
  - David Swanney (IAASB public member)

### **Background**

3. Staff has commenced a project to develop an impact assessment process for IFAC. This is done in consultation with the IAASB Task Force and an IFAC staff group. The IFAC Staff Group includes representatives of the various IFAC boards and committees, the Compliance Advisory Panel and the Communications department.
4. In developing the proposed Impact Analysis, Staff has been guided by the following criteria:
  - (a) The need to incorporate the analysis into the due process.
  - (b) The need to make the analysis scalable. In other words, its scope and depth depend on the nature of the problem being addressed.

- (c) The importance of developing an approach that is practical and can be applied by staff responsible for managing the projects of their respective boards.
- 5. Staff considered various forms of cost-benefit analysis in developing the proposed Impact Analysis and guidance presented in Agenda Item 3-A. The appendix presents an overview of these considerations.
- 6. The proposed Impact Analysis was tested by the Task Force on a recently completed project, and modified based on the task force members' experience. The example of a completed template is presented Agenda Item 3-B.

### **Consultation to Date and Planned Consultation**

- 7. The IFAC Staff Group is consulted as the project progresses.
- 8. Staff presented the principles of the proposed Impact Analysis to the Consultative Advisory Group of the International Accounting Education Standards Board (IAESB) on February 6, to the International Ethics Standards Board for Accountants (IESBA) on April 28, and to the Small and Medium Practices Committee on May 22. Staff will present an update to the IFAC Board at their meeting on June 4-5. Presentations to the other boards and, where applicable, their consultative advisory groups, and committees are planned during 2009.
- 9. IAASB Task Force chair, John Fogarty, presented the principles at the IAASB-National Standards Setters meeting on April 23-24.

### **Testing the Proposed Impact Analysis**

- 10. The IAASB is asked to test the practical application of the proposed analysis on a project to commence in the third or fourth quarter of 2009. It is proposed that this is followed by similar tests on projects of the IESBA, the International Public Sector Accounting Standards Board, and the IAESB.
- 11. The results of these tests will be used to modify the proposed analysis. In addition, they will become examples to be appended to the proposed guidance.

### **Material Presented**

|                 |  |
|-----------------|--|
| Agenda Item 3-A | Proposed Impact Analyses Guidance                            |
| Agenda Item 3-B | Illustrative Example of a Completed Impact Analysis Template |

### **Action Requested**

- 12. The IAASB is asked:
  - (a) To approve the proposed guidance in Agenda Item 3-A for testing on a future project of the IAASB; and
  - (b) To identify such future project.

## Overview of Cost-Benefit Analysis (Analysis of Impact)

### Introduction

1. One of the most difficult parts of an impact assessment is the analysis of the impact.<sup>1</sup> Many impact assessments include some analytical method for assessing regulatory impacts. The Organisation for Economic Co-operation and Development's (OECD) *Regulatory Impact Analysis in OECD Countries: Challenges for Developing Countries*<sup>2</sup> notes that, although several regulatory impact assessment methods are commonly used in OECD countries,<sup>3</sup> the trend is for countries to adopt cost-benefit analysis. The paper notes that:

This test is the preferred method of assessing regulatory impacts because it aims at producing public policy that meets the criterion of being “socially optimal.” Where this test is not applied, there is no objective standard by which ministries can justify the need for regulations, no public testing of their conclusions, and little basis for challenge.<sup>4</sup>

2. Similarly, as noted in the UK Auditing Practices Board's (APB) *Considering the Cost/Benefit of Improvement to ISAs*, “...there is increasing pressure on some standard setters to demonstrate that the cost of compliance with new or changed auditing standards is taken into account when they are developed with a view to ensuring that the cost does not outweigh the benefit.”
3. The New Zealand Ministry of Economic Development's approach<sup>5</sup> to impact assessments includes a statement of the options that were considered in achieving the objective(s) and an analysis of the impact of the options.

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<sup>1</sup> The term “analysis of impact” is used synonymously with “effect analysis” and “cost-benefit analysis.”

<sup>2</sup> Prepared by Delia Rodrigo, Administrator, Regulatory Policy Division, Directorate for Public Governance and Territorial Development. International Conference “Reforming the Business Environment,” Cairo, Egypt, 29 November – 1 December 2005.

<sup>3</sup> Benefit/cost analysis, cost effectiveness or cost/output analysis, fiscal or budget analysis, socio-economic impact analysis, consequence analysis, compliance cost analysis and business impact tests.

<sup>4</sup> Other techniques, including multi-criteria analysis and cost-effectiveness analysis, are discussed in DTLR Multi-criteria Analysis Manual, prepared by a team from National Economic Research Associates (NERA). Multi-criteria analysis (MCA) establishes preferences between options by reference to an explicit set of objectives that the decision making body has identified, and for which it has established measurable criteria to assess the extent to which the objectives have been achieved. Although the paper details advantages of MCA over informal judgment, it does note that “one limitation of MCA is that it cannot show that an action adds more to welfare than it detracts. Unlike CBA, there is no explicit rationale or necessity for a Pareto Improvement rule that benefits should exceed costs. Thus, in MCA ... the ‘best’ option can be inconsistent with improving welfare, so doing nothing could in principle be preferable.”

<sup>5</sup> Hints & Tips for Writing a Regulatory Impact Statement/Business Compliance Cost Statement (RIS/BCCS).

## Types of Analysis of Impact

4. While the basic approaches to preparing an analysis of impact are similar, the *Cost Benefit Analysis Framework* developed by New Zealand's Ministry of Economic Development (NZ CBA Framework) notes that there are different levels of cost-benefit analysis (CBA). The NZ CBA Framework discusses both a formal quantitative cost-benefit analysis and a mainly textual/qualitative cost-benefit analysis. The framework discusses the fact that the level depends on the significance of the proposal

- **Quantitative Approaches.** Many guidelines for regulatory impact assessments for governments, legislative or policy-making bodies focus on a quantitative approach to a cost-benefit analysis. While noting that quantifying costs and, in particular, benefits can be difficult, such guides recommend such an approach. For example, the RIU's *Better Policy Making: A Guide to Regulatory Impact Assessment* states, in its Regulatory Impact Assessment Checklist, that costs should be calculated and benefits should be quantified "as far as possible." This guide recommends that advice from economists be used in developing the analysis. Similarly, the New Zealand Treasury's *Cost Benefit Analysis Primer* focuses on cost-benefit analysis as an economic assessment tool. The primer notes that "by quantifying all costs and benefits in monetary terms, and discounting, it is possible to determine the net benefits (or costs) of a proposal in today's dollars. These net benefit/cost can then be used to rank quantitatively alternative proposals between a given proposal and the status quo, or between competing proposals. Decision-makers can be provided with a consistent basis for assessing proposals and can be better informed about the implications of using economic resources."
- **Combining Quantitative and Qualitative Approaches.** However, quantification of costs and benefits can be costly and difficult. The *Impact Assessment Guidelines for EU Level 3 Committees* suggests a balance between quantitative and qualitative approaches. The EU guidelines suggest that "an IA should always be qualitative. Whether or not it also needs to include some quantitative analysis depends on the extent to which it is required in order to establish whether or not the overall effect of a policy proposal will be significantly positive." The Guidelines go on to note that "not every aspect of a policy proposal needs to be quantified, only those that are expected to carry significant impacts or about which there is uncertainty in relation to the extent of their likely impact. Moreover, when the benefits of different policies are similar, it can indeed be enough to evaluate the costs of these policies in order to compare them."

The EU Guidelines also note that there can be a misperception that a quantitative analysis means that costs and benefits should be quantified as precisely as possible. The Guidelines argue that attempting to be precise exposes the analysis to unnecessary criticism. A better approach might be an underestimation of the benefits and overestimation of the costs. As long as the resulting net benefit is significantly positive, there is no need to quantify benefits and costs in a very precise way.

An example of a proposal for legislation that includes a detailed analysis of the impacts is the *Commission Staff Working Document*<sup>6</sup> accompanying the *Impact Assessment of Think Small First: A Small Business Act for Europe*. This document presents an analysis of the economic, social, and environmental impacts of various options. Although some measures of policy impacts are quantified when cost information is available,<sup>7</sup> the total impacts of certain options are compared on a qualitative basis only. The document notes that a “comprehensive quantitative assessment would require complex modeling that goes beyond the scope of proportionality for this impact assessment.”

Another example can be found in *Final Regulatory Impact Assessment on the Use of Fair Value Accounting for Certain Financial Instruments for Companies and Building Societies*. This regulatory impact assessment discusses the costs and benefits of the implementation of the *Fair Value Directive*. While this regulatory impact assessment states that it is difficult to quantify the benefits, costs have been quantified.

- **Qualitative Approaches.** The NZ CBA Framework notes that a mainly textual/qualitative CBA may be appropriate for less significant proposals. The Framework notes that this type of qualitative framework is different from a quantitative framework in two ways.
  - Whereas quantitative CBA requires that all or most impacts are quantified in dollar terms, a textual CBA will describe all of the impacts, giving assessments of magnitude where these are available. It is a “weighing up” exercise – you state the relative size of impacts compared with other quantifiable or unquantifiable impacts.
  - Whereas in quantitative CBA you calculate the net benefit and/or benefit-cost ratio, in a textual CBA the preferred option is identified by comparing the relative size of impacts without necessarily making overall calculations.

### Examples of Approaches Used by National Standard-Setters<sup>8</sup>

5. Certain national standard-setters are currently using forms of cost-benefit analysis. For example, the UK Auditing Practices Board (APB) used a quantitative approach to

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<sup>6</sup> Communication from the Commission to the European Parliament, The Council, the European Economic and Social Committee and the Committee of the Regions.

<sup>7</sup> For example, in the section on improving the administrative and regulatory burden on SMEs, the document notes that “According to the Small Business Research Trust Survey (2001) in the UK, a small business with 10-14 employees spends 31 hours a month complying with government regulation and paperwork, while an owner of a business with 50 or more workers needs 43.4 hours a month to comply, with business indicating that introducing common commencement dates would lead to an estimated 10% reduction of costs overall.”

<sup>8</sup> This discussion focuses on impact assessments considered most relevant to IFAC. However, additional detail on RIAs in specific countries, including some guidelines on how cost-benefit analysis is used in certain countries, is presented in the OECD’s Regulatory Impact Analysis (RIA) Inventory: Explanatory Note for a Survey of RIA Systems in OECD Countries” (29<sup>th</sup> Session of the Committee, 15-16 April 2004, International Energy Agency, Paris).

evaluating costs in its Consultation Paper, *Consultation on Whether UK and Irish Auditing Standards Could be Updated for the New International Auditing Standards*. In this paper, the APB Staff presents an assessment of the possible impact on the cost of individual audit engagements of applying the clarity ISAs. The possible costs are then considered in evaluating possible adoption strategies. However, benefits appear to be presented in qualitative, rather than quantitative, terms.

6. Another example is provided by the Australian Auditing and Assurance Standards Board (AUASB). The AUASB has developed a Regulation Impact Statement for *Standard on Assurance Engagements ASAE 3000, Assurance Engagements Other than Audits or Reviews of Historical Financial Information*. The document uses an impact assessment to present in a detailed table Costs and Benefits of Feasible Options. These costs and benefits are considered in qualitative, not quantitative, terms. For example, a benefit presented for one option is avoiding uncertainty over the assurance practitioner's obligations, and the cost is presented in terms of developing and undergoing new training if the new guidance was implemented.

#### **Approach Used by the IASB<sup>9</sup>**

7. The International Accounting Standards Board (IASB) recently implemented an analysis of impact in *Business Combinations Phase II: Project Summary, Feedback, and Effect Analysis* (Project Summary). After describing the main changes in practice for revised IFRS 3 and amended IAS 27, the paper presents "Feedback and Effect Analysis." The Project Summary notes "Our evaluations of costs and benefits are necessarily qualitative, rather than quantitative. This is because quantifying costs and, particularly, benefits is inherently difficult. Although other standards setters undertake similar types of analysis, there is a lack of sufficiently well-established and reliable techniques for quantifying this analysis."<sup>10</sup>
8. The following is an example from the Project Summary of the IASB's consideration of the accounting for contingent consideration in a business combination.<sup>11</sup>

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<sup>9</sup> This discussion focuses on impact assessments for other standard-setters. However, additional detail on RIAs in specific countries, including some guidelines on how cost-benefit analysis is used in certain countries, is presented in the OECD's Regulatory Impact Analysis (RIA) Inventory: Explanatory Note for a Survey of RIA Systems in OECD Countries" (29<sup>th</sup> Session of the Committee, 15-16 April 2004, International Energy Agency, Paris).

<sup>10</sup> The US FASB takes a similar approach. The FASB is also including cost-benefit considerations in the Basis for Conclusions. For Statement of Financial Accounting Standards No. 141(R) , *Business Combinations*, the FASB noted that "the Board's assessment of the costs and benefits of issuing an accounting standard is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement an accounting standard or to quantify the value of improved information in financial statements."

<sup>11</sup> The entire document can be found at [http://www.iasb.org/NR/rdonlyres/05F330F1-F148-4C8D-8E08-5ECE6F8A04F0/0/BusComb\\_Effects.pdf](http://www.iasb.org/NR/rdonlyres/05F330F1-F148-4C8D-8E08-5ECE6F8A04F0/0/BusComb_Effects.pdf).

### Cost and Benefit Assessment

| Preparers                   |          |  |
|-----------------------------|----------|--|
| Assessment                  | Effect   | Analysis   |
| Increased preparation costs | Negative | It is likely that significantly more contingent consideration arrangements will be recognized at the date of acquisition, which will require new fair value measures. There are ongoing requirements to measure any liability at each reporting date until the liability is settled.   |
| Users                       |          |  |
| Assessment                  | Effect   | Analysis   |
| Reduced analysis costs      | Positive | Analysis costs are likely to be lower as a result of the change, mainly because of the increased disclosure requirements. It will also be easier to monitor the settlement of these arrangements.  |
| Comparability               | Positive | The information should be more comparable because all contingent consideration arrangements will be accounted for in the same way.   |
| Usefulness                  | Positive | <p>We made the decision to change the accounting for contingent consideration because we think the resulting information provides a better measure of the consideration for which the acquirer is liable. It also ensures that the accounting for the business combination is more complete at the acquisition date. On this basis we think the accounting will improve the usefulness of the financial statements.</p> <p>Users, however, have told us that they are concerned that acquirers will have an incentive to overstate the liability. By doing so the acquirer is able to recognize a gain associated with a reduced obligation if the combined entity does not perform as well as expected. Therefore, the users are more skeptical about whether the information will be more useful.</p> <p>Despite the skepticism of some users, we have assessed the effect on usefulness as positive because of the improved accountability and enhanced disclosure.</p> |

9. After reviewing the model used in the IASB's Project Summary, IFAC Staff consulted with Alan Teixeira, IASB Staff responsible for the development of the Effect Analysis for the Business Combinations project. Mr. Teixeira noted that the analysis was performed ex post, at the point of preparing the Basis for Conclusions.
10. Mr. Teixeira reported that there was support for the IASB's approach. The Australian Accounting Standards Board may use the IASB's analysis in future, and the European Financial Reporting Advisory Group (EFRAG) has indicated that it will work with the IASB in this area.<sup>12</sup>

### **IFAC's Proposed Approach**

11. After consideration of a broad range of possible options, staff, in consultation with the IAASB Task Force and IFAC Staff Group, developed the proposed Impact Analysis presented in Agenda Item 3.1. This option was selected because:
  - It is inherently difficult to quantify certain costs and benefits of IFAC projects. Benefits such as improving audit quality are not easy to measure in monetary terms. It is also difficult to quantify costs associated with various projects at the international level. A qualitative analysis is both feasible and cost-effective, and provides sufficient detail to inform decision-making. Further analysis of costs and benefits, including some quantification, could be informed at the national level. Public forums, roundtables, consultation papers or exposure drafts could specifically seek information that will help the IAASB to analyze further costs and benefits. Such information would then be used in the proposed Impact Analysis to confirm the net benefit of any preferred option, and that conclusions are in the public interest. Continued research and feedback will help to build the analysis of costs and benefits at the international level and improve the process over time.
  - It provides a uniform and consistent approach to the analyses of impacts that will help preparers, users, and regulatory authorities to understand the considerations made and conclusions reached in the development of standards.

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<sup>12</sup> EFRAG has been evaluating the costs and benefits associated with implementing IFRS. These analyses are part of the initiative by the European Commission to gather information on the costs and benefits of all new or revised Standards or Interpretations as part of the endorsement process. EFRAG's Effects Study Report *IFRS 3R, Business Combinations and IAS 27A, Consolidated and Separate Financial Statements*, notes that EFRAG started its assessment using the effects study work conducted by the IASB. EFRAG then supplemented its analysis with additional consultation to form the basis for its report. In another example, *The Costs and Benefits of Implementing the Amendment to IFRS 2 – Share-Based Payment: Vesting Conditions and Cancellations in the EU*, EFRAG was of the view that since IFRS 2 is an amendment only, the cost and benefit implications can be assessed with a more modest amount of work.