

On the Road to an Objectives-Oriented Accounting System

The Road behind Us

In January 2002, the Board decided to address the broad issue of standards overload through a series of initiatives aimed at simplifying and codifying the accounting literature. One of those initiatives led to the issuance of the FASB proposal, *Principles-Based Approach to U.S. Standard Setting* (the Proposal) in October 2002. The Proposal was issued in response to concerns about the quality and transparency of financial reporting resulting from the increasing level of detail and complexity in the standards. In March 2003, the Board discussed the comments received on the Proposal (including input from the SEC staff) and decided to pursue a number of initiatives aimed at improving the quality of FASB standards as well as the standard-setting process itself.

The Sarbanes-Oxley Act of 2002 directed the Securities and Exchange Commission (SEC) to conduct a study on the adoption by the U.S. financial reporting system of a principles-based standard-setting process and to submit a report to Congress on that study. In July 2003, the SEC staff submitted its report to Congress, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (the Report). The Report included a number of recommendations directed at the FASB, many of which were consistent with initiatives we already had under way.

The Board and staff held numerous discussions about those recommendations in the months following issuance of the Report. In January 2004, we met with the SEC staff to discuss our views and plans for addressing the recommendations. Some of those plans included the International Accounting Standards Board (IASB) and were to be discussed at the April 2004 joint meeting of the two Boards; therefore, we waited until after that meeting to send our formal response to the SEC. That formal response was sent to SEC Chief Accountant Donald Nicolaisen in July 2004. A copy can be found on our website (www.fasb.org).

The Road Ahead

The primary recommendations in the Report were for the FASB to issue objectives-oriented standards and to address deficiencies in the conceptual framework.

Objectives-Oriented Standards

An objectives-oriented standard is described in the Report as having the following characteristics:

- Be based on an improved and consistently applied framework

- Clearly state the accounting objective of the standard
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis¹
- Minimize exceptions from the standard
- Avoid use of percentage tests (“bright-lines”) that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard. [page 4]

The following describes our plans for issuing standards that include those characteristics.

Conceptual Framework

In the Report the SEC recommended that we improve our conceptual framework as we move toward a more objectives-oriented approach to setting standards. In March 2003, after discussing the comments received on its Proposal, the Board agreed that its conceptual framework needs to be improved. This is because an internally consistent and complete conceptual framework is critical to a standard-setting approach that places more emphasis on the underlying principles that are based on that framework.

We have been working on making necessary changes to the Concepts Statements in three of our current projects: Revenue Recognition, Liabilities and Equity, and Fair Value Measurements. At our joint meeting in April 2004 with the IASB, we agreed to work together to develop a single, complete, and internally consistent conceptual framework that would be used by both Boards. In undertaking that project, we plan to complete and refine our existing framework rather than comprehensively reconsider all components of that framework.

Format and Content of Standards

While existing FASB standards are based on concepts and principles, we believe that the understandability of future FASB standards could be improved by writing them in a way that (a) clearly states the accounting objective(s), (b) clearly articulates the underlying principles, and (c) improves the explanation of the rationale behind those principles and how they relate to the conceptual framework.

We are working on developing a format for our standards that will encompass the attributes of an objectives-oriented standard, for example, describing the underlying objective of the standard in the introductory paragraphs, using bold type to set off the principles,² and providing a glossary for defined terms. In addition, we are working with a consultant to identify changes in the structure and appearance of our standards that will increase the understandability of those standards. By their nature accounting standards will include many specific technical terms;

however, we believe we can do a better job simplifying the language used in our standards to describe how to account for complex transactions.

When discussing proposed accounting standards or specific provisions of a standard, many of our constituents comment on whether a standard is “operational.” Because *operational* can mean different things to different people, we decided to define that term for purposes of our internal discussions. We use the term *operational* to mean the following:

- A provision/standard is comprehensible by a reader who has a reasonable level of knowledge and sophistication.
- The information needed to apply the provision/standard is currently available or can be created.
- The provision/standard can be applied in the manner in which it was intended.

We hope that by making our standards more understandable, they also will be more operational.

Implementation Guidance

As noted in our October 2002 Proposal, an approach to setting standards that places more emphasis on principles will not eliminate the need to provide interpretive and implementation guidance for applying those standards. Thus, we agree with the SEC staff that some amount of implementation guidance is needed for entities to apply objectives-oriented standards in a consistent manner.

We believe that there should be enough guidance such that a principle is understandable, operational, and capable of being applied consistently in similar situations. Judgment will be required to decide how much guidance is needed to achieve those objectives without providing so much guidance that the overall standard combined with its implementation guidance becomes a collection of detailed rules. Therefore, the amount and nature of implementation guidance will vary from standard to standard. Furthermore, the Board believes that its primary focus should be providing broadly applicable implementation guidance, not providing guidance on relatively narrow and less pervasive issues, including, for example, issues that are specific to certain entities or industries.

We intend to continue to include examples in our proposed and final standards. However, because the purpose of examples is to illustrate the application and intent of the underlying principles in a standard, they should be viewed as additional guidance in applying and understanding the standards—not as rules that should be followed.

Scope Exceptions

An objective of having few, if any, scope exceptions in our standards was an important aspect of the Board’s Proposal as well

as the SEC’s Report. Accounting standards that include few, if any, exceptions to the principles will increase the extent to which similar transactions and events are accounted for similarly. This will thereby enhance comparability and reduce the level of detail and complexity that arises from exceptions. The Board will continue to be diligent in making rational and consistent scope decisions and mindful of the goal of having relatively few scope exceptions.

Use of Bright Lines

The Report discussed the importance of and need for preparers and auditors to exercise appropriate professional judgment in applying accounting standards based on the stated objectives and principles and consistent with the economic substance of transactions and events. The SEC staff, in our view, correctly pointed out that detailed rules, bright lines, exceptions, and treatment alternatives can act as a barrier to achievement of these objectives. In addition, the Report noted that while detailed rules and bright lines may increase the perceived consistency and comparability of financial information, they can result in “false comparability” and reporting based on form rather than substance. We agree with all of those observations and will do our best to limit the use of bright lines and treatment alternatives in future standards.

The Side Roads along the Way

The Report included a number of recommendations indirectly related to the topic of principles-based standards. Two of those recommendations are addressed below.

Redefine the GAAP Hierarchy

The Report recommended that the various levels of the GAAP hierarchy be eliminated and that the conceptual framework be given greater prominence in the GAAP hierarchy. As noted in the Report, because the conceptual framework is intended primarily to aid the Board in its deliberations, the existing GAAP hierarchy places industry practice above the FASB’s conceptual framework.

We agree with the recommendation in the Report and plan to issue a document for public comment that will propose moving the GAAP hierarchy into the FASB literature. Our long-term goal is to have only two levels of accounting literature: authoritative and nonauthoritative.

Increase Access to Authoritative Literature

When we began our codification and simplification initiatives, one of the concerns we hoped to address was the frustration of accounting professionals over the difficulty in retrieving all of the accounting literature on a specific topic. The Report recommended that we develop and maintain a searchable database containing all of the authoritative guidance. Citing the funding

mechanism for the FASB put in place by the Sarbanes-Oxley Act, the Report suggested that in the long-run FASB literature should be freely available. At this time, FASB standards, Interpretations, and Concept Statements are freely available on our website, but not in a searchable database.

We are studying the possibility of undertaking a project to integrate and synthesize all of the U.S. accounting literature into a single authoritative, electronically searchable source. If this codification and retrieval project moves forward, it will be a major undertaking that will span a number of years. We believe a project of this nature is very important given the current disorganized state of U.S. GAAP as evidenced by the more than 20 different types of literature that have been issued by multiple standard setters over the last 50+ years.

The Journey

The Report emphasized that a move toward more objectives-oriented standards will require shifts in attitude, behavior, and expertise of preparers and auditors. We believe that it may take several years or more for such attitudes and behavioral changes to take root. One reason for that belief is that preparers continue to request scope exceptions, scope exemptions, and treatment alternatives, and to oppose changes that would eliminate existing scope exceptions and treatment alternatives. In addition, our recent experience suggests that many preparers and auditors have become less willing to exercise professional judgment in areas involving accounting estimates, uncertainties, and inherent subjectivity. Instead, they have been requesting detailed rules and bright lines in an apparent effort to reduce the need for the exercise of judgment in inherently subjective areas. Increased accountability for the accuracy of financial information under the new requirements related to the Sarbanes-Oxley Act coupled with a fear of “second guessing” by enforcement agencies and the trial bar are frequently cited as reasons for this behavior.

We are committed to working with the SEC, the Public Company Accounting Oversight Board (PCAOB), and our constituents to foster the behavioral changes necessary to support the type of objectives-oriented accounting standards envisaged in the Report.

If you have any questions or comments on this initiative, please contact Kim Petrone, FASB Director of Planning, Development, and Support Activities, at krpetrone@fasb.org.

¹ In doing so, however, standard setters must avoid the temptation to provide too much detail (that is, avoid trying to answer virtually every possible question within the standard itself) such that the detail obscures or overrides the objective underlying the standard. [Footnote in original.]

² The Board is considering using the black-letter/gray-letter style of the IASB and will use that style in its business combinations Exposure Draft. The Board intends to request constituent input on that style and will address the advantages and disadvantages of using that style in all FASB standards at a later date.