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INSTITUT  
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**IDW**

June 21, 2005

Technical Director  
Financial Accounting Standards Board  
Of the Financial Accounting Foundation  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116  
USA

By E-mail: [director@fasb.org](mailto:director@fasb.org)

Dear Director:

**Re: File Reference No. 1300-001**

**IDW Comment Letter on the Exposure Draft of the Proposed Statement of Financial Accounting Standards: The Hierarchy of Generally Accepted Accounting Principles**

We would like to thank you for the opportunity to provide the Financial Accounting Standards Board (FASB) with our comments on the Exposure Draft of the Proposed Statement of Financial Accounting Standards: The Hierarchy of Generally Accepted Accounting Principles (hereinafter referred to as "the Standard").

### Introduction

The Institut der Wirtschaftsprüfer in Deutschland e.V. [Institute of Public Auditors in Germany, Incorporated Association] (IDW) represents over 85 % of the Wirtschaftsprüfer [German Public Auditors] profession in Germany. Only German Wirtschaftsprüfer are empowered by German law to perform statutory audits of financial statements of business enterprises whose securities are publicly traded, of Aktiengesellschaften [German stock corporations] and of large German Gesellschaften mit beschränkter Haftung [German limited liability companies].

Institut der Wirtschaftsprüfer  
in Deutschland e.V.  
Tersteegenstr. 14  
40474 Düsseldorf  
Postfach 320580  
40420 Düsseldorf

Telefonzentrale 0211/4561-0  
Fax Geschäftsleitung 0211/4541097  
Fax Fachabteilung 0211/4561233  
Fax Bibliothek 0211/4561204  
Internet [www.idw.de](http://www.idw.de)  
E-Mail [info@idw.de](mailto:info@idw.de)

Geschäftsführender Vorstand:  
Prof. Dr. Klaus-Peter Naumann,  
WP StB, Sprecher des Vorstands  
Dr. Gerhard Gross  
Dr. Wolfgang Schaum, WP StB

Bankverbindung:  
Deutsche Bank AG  
Düsseldorf  
BLZ 300 700 10  
Kto. Nr. 7 480 213

We are writing this letter to you because a significant number of our members and member accounting firms are directly affected by fundamental changes to US GAAP. Our members are affected due to their involvement in the audits of business enterprises in Germany that prepare financial statements, including reporting packages, in compliance with U.S. generally accepted accounting principles (US GAAP). These US GAAP financial statements are prepared because these enterprises are SEC registrants or subsidiaries thereof, are subsidiaries of privately held U.S. business enterprises, or choose to prepare US GAAP financial statements on a voluntary basis.

We also believe that due to the memorandum of understanding ("Norwalk Agreement") that moves the formalization of the commitment to the convergence of U.S. and international accounting standards forward, fundamental pronouncements relating to US GAAP of this nature will have a major impact on future standards setting for International Financial Reporting Standards (IFRS) by the International Accounting Standards Board (IASB).

Rather than address all of the issues that arise in relation to the contents and structure of the Hierarchy based on the relative due processes used to issue the pronouncements, we have chosen to concentrate on what we consider to be the issues that may have the greatest international impact.

### **General Views**

We are broadly in favor of the Standard because the GAAP Hierarchy applies not only to auditors, but also to preparers and therefore should be included in accounting, rather than auditing, standards. In particular, we are also in favor of the prohibition of departures from US GAAP when enterprises represent that financial statements are presented in accordance with US GAAP, because in our view such a statement in conjunction with departures would constitute a misrepresentation. We recognize that this prohibition would conflict with Rule 203 of the AICPA Code of Professional Conduct, but the Rule 203 departure has rarely – if ever – been used in recent years. Consequently, we recognize that the AICPA may need to revise this Rule if the FASB issues the Standard with the noted prohibition. Furthermore, although IFRS includes such a "departure" provision for extremely rare circumstances, we believe that this provision is not appropriate for the same reasons that we support the prohibition of departures from US GAAP.

Nevertheless, we believe that the Standard contains weaknesses in the following respects:

1. The Standard does not provide guidance on the relationship between GAAP and the legal, regulatory and ethical environment in which GAAP are applied.
2. The Standard does not address the consequent relationship between fair presentation and US GAAP.
3. The Standard does not address the possible need to provide disclosures beyond those specifically required by US GAAP to achieve fair presentation.
4. The Standard as currently written tends to strengthen the impression that the application of US GAAP is a mechanical exercise devoid of judgment, rather than recognizing that the exercise of judgment is central to both the preparation and audit of financial statements.

We will address each of these issues in turn.

### **The Application of US GAAP in its Legal, Regulatory and Ethical Environment**

We believe it to be of crucial importance for FASB standards to recognize that US GAAP are not applied in an environmental vacuum and that therefore the application of US GAAP is influenced by the legal and ethical environment in which professional accountants operate. This legal and ethical environment includes statutes, regulations, court decisions and professional ethical obligations in relation to accounting matters. We believe that the US GAAP hierarchy ought to incorporate these factors between paragraph 3d of the Standard and paragraph 5 (analogous application of accounting principles for similar transactions or events and other accounting literature). In our view, this would not constitute a change in practice, but simply reflect current conditions.

Along these lines, the legal imperative for “fair presentation” and its influence on the application of US GAAP flows directly from the legal, regulatory and ethical environment.

### **Requirements and Guidance on the Meaning of “Fair Presentation in Accordance with US GAAP”**

The legal responsibilities of preparers and auditors for financial statements in the U.S. and many other common law jurisdictions have always gone beyond one of “pure compliance”. In other words, due to the lack of direct legal sanction for generally accepted accounting principles, the courts have always deemed the defense “literal compliance with generally accepted accounting principles” alone not

to be enough, even though they would accept such compliance as *prima facie* evidence of preparers and auditors having fulfilled their legal responsibilities. This fair presentation requirement was also incorporated into Section 302 (a) (3) of the Sarbanes-Oxley Act. Furthermore, Codes of Professional Conduct for professional accountants internationally and in various jurisdictions, including the U.S., prohibit professional accountants' association with misleading information.

Given the legal requirements for preparers and auditors to certify or provide an opinion on, respectively, whether the financial statements fairly present the financial position, results from operations and cash flows of the enterprise, we strongly believe that the FASB would be remiss in not having the Standard provide requirements and guidance for the use of the term in conjunction with US GAAP. The FASB should be cognizant that if the FASB were to choose not to provide such requirements and guidance, this gap would likely continue to be filled by auditing standards setters (or others) even though the matter is an accounting issue that applies to both preparers and auditors.

In considering the requirements and guidance on the meaning of fair presentation, the FASB may need to look at two aspects thereof: the legal "full and fair disclosure" requirement together with ethical requirements for professional accountants, and the issues surrounding the application of professional judgment.

### **The Possible Need to Provide Disclosures Beyond Those Specifically Required by GAAP**

In consonance with the Standard, "fair presentation in compliance with US GAAP" has not recently been interpreted by U.S. courts as requiring a departure from the recognition, measurement, presentation or disclosure requirements of US GAAP. However, the courts have interpreted "fair presentation" as encompassing "full and fair disclosure" beyond the requirements of US GAAP if necessary for "fair presentation". In addition, Professional Codes of Conduct prohibit the association of professional accountants with misleading information. Consequently, to prevent legal liability on their part and ensure their compliance with ethical requirements, when applicable, both preparers and auditors must ensure that financial statements that claim to be fairly presented, and hence not misleading, include all of the disclosure necessary to ensure their "fair presentation" of the financial position, results of operations and cash flows of an enterprise, even if these disclosures are not specifically required by US GAAP.

We understand that, at a philosophical level, the FASB might like to limit the assertions in relation to US GAAP financial statements to pure compliance with

GAAP: we are partial to that argument. Unfortunately, this philosophy, which essentially entails the belief that there is no “fair presentation” out there beyond the criteria in US GAAP, does not appear to reflect legal reality in either the U.S. or other common law jurisdictions. Furthermore, it does not allow for the possibility that financial statements prepared in accordance with US GAAP could still be misleading within the meaning of Codes of Professional Conduct for professional accountants. Consequently, although the disclosures required by US GAAP will normally suffice for financial statements to present fairly the financial position, results of operations and cash flows of an enterprise, disclosures beyond those specifically required by US GAAP may be necessary for fair presentation and for the financial statements not to be misleading.

We would like to point out that recognizing the potential need for additional disclosures beyond those specifically required by the financial reporting framework is specifically recognized by the IFRS in the second sentence of IAS 1.13. The principle that disclosures beyond those specifically required beyond the financial reporting framework may be necessary to achieve a “true and fair view” is also incorporated into Articles 4 and 16 of the Fourth and Seventh EU Directives, respectively. Consequently, the inclusion of such a provision would further the convergence of US GAAP with IFRS and other financial reporting frameworks for general-purpose financial statements.

This issue of additional disclosure is closely intertwined with that of the quality of disclosures – particularly for qualitative aspects of disclosures for which it may be difficult to distinguish between “additional” and “better quality” disclosures. Determining whether disclosures need to be qualitatively improved either by means of “additional” disclosures or disclosures of “better quality” is an issue involving considerable professional judgment, which leads to the last, and perhaps most important weakness of the Standard.

### **The Exercise of Professional Judgment in Preparing and Auditing Financial Statements**

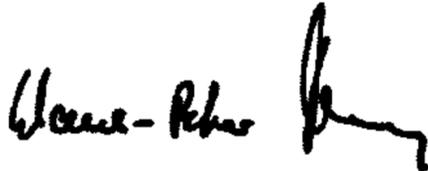
We found it rather unfortunate that the FASB has chosen to incorporate the “GAAP Hierarchy” portion of AU §411, but chose to ignore the equally important further guidance on the meaning of “present fairly in conformity with GAAP” as discussed in AU §411.02 - .04 and §411.06. As described in these paragraphs in AU §411, the application of accounting pronouncements to specific circumstances and the choice of accounting methods and techniques to prepare (and hence audit) financial statements requires the exercise of sound professional judgment to determine the economic substance as opposed to the legal form of transactions. In particular,

considerations resulting from legal and ethical requirements have a major impact on the application of GAAP in particular circumstances – especially when disclosure issues are involved. Furthermore, the judgments made in AU 411.04 need not only be performed by auditors, but should also be performed by preparers, and therefore ought to have been adopted in some form. The way the Standard reads now it leaves the impression that the application of US GAAP is a mechanical exercise, which we believe the FASB would agree it is not.

Consequently, we believe it to be in the interests of good financial reporting that the FASB incorporate into the Standard the guidance from AU §411.

If you have any further questions about our views on these matters, we would be pleased to be of further assistance.

Yours truly,



Klaus-Peter Naumann  
Chief Executive Officer



Wolfgang P. Böhm  
Special Advisor to the Executive Board

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