

Comments on the FASB's Proposal

## PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING

These comments are submitted by the Principles-Based Approach to U.S. Standard Setting Project Team of the Indiana CPA Society. However, the comments have no official status and do not represent either the approval or the disapproval of the exposure drafts by the Society or its Board of Directors."

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Adopting a principles-based approach to U.S. standard setting would constitute an important step in transforming and elevating the accounting profession and foster convergence with international accounting standards. A transition period would be needed to get full commitment from all constituencies to this approach, rewrite the conceptual framework, and make changes in the legal environment surrounding financial accounting and auditing as well as in education. The hurdles in properly implementing this approach in the U.S. could be significant but it seems to be a necessary step since we do have an obligation to make improvements in financial reporting on behalf of investors, to try to prevent future Enrons.

### **1. Do you support the Board's proposal for a principles-based approach to U.S. standard setting? Will that approach improve the quality and transparency of U.S. financial accounting and reporting?**

In theory, we strongly support the Board's proposal for a principles-based approach to U.S. standard setting. Whether it will improve the quality and transparency of financial accounting will depend on the underlying motives of the owners, preparers and other involved parties of financial reporting. If their desire is to improve the quality of the reporting in order to provide the most faithful representation of the entity's economic and financial position, then we believe a principles-based approach would definitely enhance the ability to do so. If, however, their motives are to present their statements in a light to "look good", a principles-based approach has nothing inherent to stop manipulation.

Weaknesses of our financial reporting system concerning timeliness, transparency, and complexity evolved over many years and are more visible as a result of Enron's failure. Enron makes more apparent the immediate need for necessary changes in our system. Critics of our current system indicate major weaknesses, including:

- The current standard-setting process is too cumbersome and slow.
- Much of the recent FASB guidance is rule-based and focuses on the "check-the-box" mentality that inhibits transparency. It encourages accounting engineering to structure transactions around the rules to attain form over substance results, circumventing the intent and spirit of the standards.
- Much of the recent FASB guidance is too complex and costly to apply.

We believe that a principles-based approach will improve the quality and transparency of U.S. financial accounting and reporting. Advantages of this approach include:

- Financial reporting which reflects the economic substance, not the form, of the transaction (i.e., the issue of effective vs. legal control as a requirement to consolidate entities, or criteria for recognizing capital vs. operating leases).
- Accounting standards which are less complex, easier to understand, and more responsive to emerging issues. Simplification of accounting standards is needed (i.e., FASB Statement No. 133 on accounting for derivatives and hedging is one of these standards which has been subject to criticism for being too complex).
- Reduction in the extent of form over substance accounting engineering to structure transactions around more specific rules, because there would be fewer exceptions to the principles and fewer potentially conflicting rules.
- Enhanced professionalism in reporting and auditing of financial statements since preparers, auditors, audit committees, and boards will be required to apply professional judgment to a greater extent consistent with the intent and spirit of the standards. The SEC staff's review and enforcement activities will also be affected.
- Better coordination with the SEC's financial reporting and disclosure reform.
- Fostering of short-term convergence with the International Accounting Standards Board and other major national standards that already use more of the principles-based approach. In an era of continuing globalization of business and capital markets, financial reporting should be comparable across borders or at least across the major capital markets. The European Union's new legislation dictates that IASB standards be used by all listed companies starting, for the most part, in 2005.
- Easier incorporation of the power of technology (i.e., XBRL) in the reporting and data analyses processes.
- Contributes to ensuring U.S. continued leadership in the world's financial markets.

**2. Should the Board develop an overall reporting framework as in IAS 1 and, if so, should that framework include a true and fair view override?**

The Board should develop an overall reporting framework as in IAS 1. An overall reporting framework would be good and would go well with the conceptual framework model. Whether or not it should include a true and fair view override to deal with extremely rare circumstances in which management concludes that compliance with a requirement in an accounting standard would be so misleading that it would conflict with the objectives of financial accounting and reporting, does not seem an important issue. To do so should not detract from the framework, but does not seem essential or even overly important due to provisions already in place in Rule 203 and currently implied in the conceptual framework (which could be fine-tuned in

the reworking of the conceptual framework in this process). If this true and fair view override works in the U.K., it should also work in the U.S.

Moving to a new approach will require the conceptual framework to be rewritten within the next couple of years based on accounting principles, with fewer exceptions to the principles, and less potentially conflicting rules. New accounting standards on consolidation accounting, for example, would probably require new standards of accounting for investments. The Board would need to commit resources to a project to improve the conceptual framework, which should be complete, internally consistent, and clear.

**3. Under what circumstances should interpretive and implementation guidance be provided under a principles-based approach to U.S. standard setting? Should the Board be the primary standard setter responsible for providing that guidance?**

Principles-based standards must be accompanied by some examples and illustrations and sufficient application guidance, which should be principles-based as well, in order to enable consistent interpretation and application. The Board after establishing guidelines to identify situations in which interpretative and implementation guidance is appropriate, should resist pressures to provide guidance in other situations.

Ideally, the Board should be the primary standard setter for providing guidance with input from AICPA, SEC, users and preparers. The Board is the most independent and has first-hand knowledge of the thought process they employed in setting the standards and therefore the most knowledgeable in how they should be applied.

Although the Board should be the primary standard setter responsible for providing that guidance, the Board should cooperate closely with and seek input from other organizations including the SEC, AICPA, and EITF. The SEC can play an active oversight role vis-à-vis FASB. The SEC should be able to require FASB to address critical issues and promulgate standards in a short time frame rather than the years it currently takes for principles to be announced (i.e., FASB consolidation project on agenda for 18 years, but no consensus).

**4. Will preparers, auditors, the SEC, investors, creditors, and other users of financial information be able to adjust to a principles-based approach to U.S. standard setting? How might those benefits and costs be quantified?**

A move to principles-based standards requires greater discipline and changes in behavior by preparers, auditors, the SEC, investors, creditors, and other users of financial information. Moving away from a check-the-box approach to financial reporting means that all constituencies must make efforts to report transactions consistent with the objectives of the standards. It requires preparers, auditors and others to be willing to exercise professional judgment, to resist seeking specific rulings on every implementation issue, and to view accounting, based on the

November 4, 2002 remarks of Robert H. Herz, Chairman of the FASB, as an exercise in good communication and not just compliance.

If auditors and preparers are diligent and faithful in the presentation of accurate financial statements and in exercising professional judgment grounded in a firm understanding of the principles, then we believe the investors and creditors will adjust rapidly in accepting the financial reporting results from a principles-based approach. In order for this to happen, we must figure out a way to ensure the overall understanding of the principles by the individuals in the professional community and to install a true desire to make judgments based on following the principles rather than on how to make things look good. We believe this might involve a major overhaul of how we as accountants have come to view our profession and our roles as professionals. It also will involve a change in how we educate both those who are to enter the profession as well as the individuals already practicing. This change would require moving from “how did we do this last year” to understanding the underlying principles behind the transactions.

A principles-based approach will require changes to the legal and litigation framework surrounding financial accounting and auditing. Preparers and auditors could face situations where compliance with detailed rules may not be sufficient to avoid litigation if the substance is lacking. In moving to a new approach, all participants must be concerned about fair presentation, and there must be enough certainty to avoid unfair liability for good faith efforts to follow standards.

**Benefits:**

- Reducing future audit fees as all parties strive for a better understanding and representation of financial reporting
- Restoring investors’ confidence in the financial reporting system
- Preventing future Enrons
- Elevating the accounting profession
- Attracting smart young people to the accounting profession

**Costs:**

- Committing resources to a project to improve the conceptual framework including developing disclosure requirements
- New approach to education and training of accountants and auditors
- New format for the CPA exam

Not all problems concerning financial reporting can be cured with regulations or legislation; for example, in the aftermath of Enron, there are serious ethical issues to consider and address.

**5. What other factors should the Board consider in assessing the extent to which it should adopt a principles-based approach to U.S. standard setting?**

Comparability of financial statements could be reduced because more general standards leave more room for different interpretations by preparers and accommodations by auditors, unless new disclosure requirements will be enacted.

A new framework for developing disclosure requirements will be needed as we move to a principles-based approach, requiring more disclosures in financial statements explaining how a company implemented the particular principles. Companies should be required to identify the most critical accounting principles upon which a company's financial status is based, and which involve the most complex, subjective, or ambiguous estimates. Investors should be told clearly how these principles are applied, and be given information about a range of possible effects in differing applications of these principles.

How can we assess the ability of preparers and auditors to render "correct" professional judgments? How equipped is the practicing community in even remembering the principles they once learned? What are the results of the SEC Study dictated by the Sarbanes-Oxley Act, Section 108(d)?

Perhaps the Board should begin by reviewing the conceptual framework and adapt any changes necessary to make it a stronger foundation for the standards and a more obvious plumb line by which to measure them. FASB Statement Nos. 141, Business Combinations, and 142, Goodwill and Other Intangible Assets, issued in 2001, appear to be in the direction of a more principles-based approach.

We totally agree with the comments made in "Commentary on Financial Reporting – Economic Consequences: The Volatility Bugaboo" by Robert T. Sprouse (pages 7-8 of proposal). We hope that any movement towards a principles-based approach would preclude the ability of standards to "allow or permit" the changing of a principle solely for the purpose of avoiding volatility in the income statement.

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