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Subject: File Reference 1125-001

Dear Ms. Bielstein:

The Edison Electric Institute (EEI) appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB) Proposal on a Principles-Based Approach to U.S. Standard Setting.

EEI is the association of the United States investor-owned electric utilities and industry affiliates and associates worldwide. Its U.S. members serve over 90 percent of all customers served by the investor-owned segment of the industry. They generate approximately three-quarters of all the electricity generated by electric utilities in the country and serve approximately 70 percent of all ultimate customers in the nation. EEI members own a majority of the transmission and generation facilities in the nation.

We have organized our comments according to the questions outlined in the Proposal.

**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?**

EEI finds the idea of a principles-based approach, governed by the principle that accounting should reflect the economic substance of business transactions and activities, to be an attractive concept. A well-designed, well-functioning principles-based approach would have the following benefits:

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- Financial statements would present a more accurate reflection of the economics of the underlying business activities.
- Financial statements would be more transparent. Instead of “boilerplate” statements and disclosures, more customized information could be presented to users to reflect the specific circumstances of the particular business. However, as a result, greater diversity in application is likely under principles-based standards.
- There would be less opportunity for “financial engineering” to design form-driven transactions that do not reflect the economics of the underlying transactions.
- Principles-based standards might ease international accounting standards convergence. In fact, such a fundamental change in standard-setting should not be undertaken unless international standard setters are fully supportive of principles-based standards.

However, EEI feels that more information is needed before we can determine whether we would support or oppose a move to principles-based standard setting. Specifically, we would like to see the following issues addressed:

1. Is it realistic to expect that all of the various parties with an interest in the financial reporting process could adjust to a principles-based approach? EEI believes that these adjustments are absolutely critical to a successful change to a principles-based approach, and that FASB should carefully consider the likelihood of these necessary adjustments before actively considering a change to a principles-based approach. This issue is addressed in more detail in our response to Question 4.
2. There needs to be a clearer definition of what the characteristics of a “principles-based” approach would be. This issue is addressed below.
3. A principles-based approach would probably require a comprehensive reconsideration of financial accounting concepts, as these concepts would have a more direct bearing on standards under a principles-based approach. This issue is addressed in our response to Question 2.
4. A process for the establishment and dissemination of implementation guidance needs to be established. This issue is addressed in our response to Question 3.

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EEL believes that it is critical for these issues to be addressed and resolved in order for a principles-based approach to be successful.

#### *Characteristics of a Principles-Based Approach*

EEL believes that the Proposal contains an overemphasis on the absence of exceptions as a defining characteristic of a principles-based approach. We believe that there are two shortcomings to this overemphasis:

1. There appears to be an assumption that the foundations underlying existing accounting standards, which contain exceptions in many cases, are by definition principles-based. In many instances, we do not believe this to be true, and in fact believe that the fundamental premise of many existing standards is quite form-driven.
2. Because of this underlying assumption, we believe that the FASB may underestimate the magnitude of the changes necessary to convert existing US GAAP to a principles-based approach.

Rather than the presence or absence of exceptions as the primary defining characteristic of a principles-based approach, we believe that the overriding characteristic of such an approach would be standards that are based on the economic substance of transactions, rather than their legal form.

To illustrate these concerns consider the Proposal's use of SFAS No. 133 as an example of a standard that is not principles-based because of its numerous exceptions and interpretations. EEL agrees that SFAS 133 is not a principles-based standard, but we disagree as to the cause. SFAS 133 is a form-driven standard which ignores the economic substance of transactions; in our view, this is the reason it is not principles-based.

Indeed, SFAS 133's many exceptions and interpretations represent attempts by users, auditors and standard setters to inject economic substance into a form-driven, rules-based standard – in other words, in our view, the exceptions and interpretations of SFAS 133 are closer to being principles-based than is the standard itself. This is most vividly illustrated by DIG Issue K1, which indicates that if a strict application of the standard's provisions to certain transactions could lead to subversion of the standard's intent, then the standard's provisions can be applied differently if certain indicators are present.

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Under SFAS 133, simple changes in the contractual form of transactions can cause significantly different accounting results. This would clearly not be the case under a principles-based approach, as we understand the concept.

A principles-based standard for accounting for derivatives would set forth the three broad models that could apply – mark-to-market through earnings, hedge accounting, and accrual accounting (normal purchase/sale) – and would provide guidelines, based on economic substance, as to which types of transactions should be accounted for under which model. Restrictions on hedge and accrual accounting could still be a part of a principles-based standard.

The application of this type of standard would then, properly, allow for transactions with similar legal form to be accounted for differently, based on their economic substance. For example, a fuel supply agreement with both forward and option-like characteristics would be accounted for by a speculator using the mark-to-market model, whereas the same contract might be accounted for as a normal purchase by an entity with a physical asset that required the fuel supply for normal operations.

Under SFAS 133, these two significantly different economic situations are accounted for identically because of the form of the contract. In our view, this is the result of applying a form-driven, rule-based standard. Many current US GAAP standards reflect this approach to standard setting and would require revision in order to adopt a principles-based approach.

In summary, EEI believes that it is important that the definition and characteristics of a principles-based approach be laid out in detail and fully vetted, in order for all participants in this process to understand the ramifications of this approach.

**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?**

EEI supports a “true and fair view override” being included in a comprehensive conceptual framework. This type of provision would not be markedly different from a similar provision that exists in current auditing standards, whereby auditors are allowed to accept the application of non-GAAP accounting in the rare circumstance in which application of GAAP accounting would present misleading results.

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We also agree with the proposal's assertion that one prerequisite to a principles-based approach would be development of a conceptual framework that is complete, internally consistent, and clear. Further, we also strongly believe that an equally important priority for such a framework is to be sensitive to, and to explicitly consider and incorporate, the time-tested objectives, needs, and uses of the actual readers and preparers of financial statements, rather than simply reflecting a theoretical, academic view. Balancing these considerations is critical to creating a workable, widely accepted framework. We offer our specific comments on these issues below.

We believe that a major weakness in both the existing conceptual framework, as well as many recent standards based on that framework, is the lack of a comprehensive model for the income statement. Both the conceptual framework and many standards have the balance sheet as their primary focus, and they either ignore the income statement or view it as a "plug" for changes in the balance sheet. While this view may be academically or theoretically supportable under the current framework, it ignores the practical, real-world needs and uses of financial statements. For example:

- The primary focus of many investors and analysts is quarterly earnings amounts based on GAAP income statements;
- Valuation methodologies for equity securities (such as price/earnings ratios or revenue multiples) often are based upon reported GAAP income statement measures;
- Over half of recent SEC Accounting and Auditing Enforcement Releases, and nearly 90% of those that were financial statement-related during the twelve months ended September 30, 2002, involved income statement issues.

It is true that the integrity of the balance sheet is important. It is also true that the income statement is equally important (and perhaps relied upon more often in many instances) in the day-to-day operation of businesses and the capital markets. Yet while the balance sheet has been the focus of much comprehensive thought, the principles governing the income statement have only been articulated through numerous specific accounting standards, and there has been no attempt to reconcile those pronouncements or to provide an equally robust conceptual basis for the income statement. Therefore, any conceptual framework must be enhanced substantially to remedy this deficiency.

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A second important consideration that must be addressed is a balancing of conceptually or theoretically pure principles with understandable, useable financial statements. For example, the form-driven "principles" underlying the definition of a derivative in SFAS No. 133 indicate that the only relevant measure for derivatives is fair value. However, the complexity and subjectivity inherent in determining the fair value of long-term or illiquid derivatives introduces into the financial statements recorded assets, liabilities, income, and expense that may neither reflect the substance of the business activity involved, nor be understandable or useful to investors, analysts, or management. The willingness of financial statement users to accept accounting standards, and the ability of financial statement preparers to implement those standards accurately and in accordance with their spirit, is enhanced when those standards are perceived as relevant, understandable, and reflective of the substance of the underlying transactions and business activities. These considerations must be balanced with our perception of the current emphasis on a theoretical or academic approach in order to develop a workable conceptual framework.

Third, it is important that any framework address the existence of the mixed attribute model. In addition to factors articulated elsewhere in this letter, we believe that the need for many exceptions in existing standards arises, at least in part, from the use of such a model. For example, the reality of preparers' and users' desire for the hedge accounting exception in SFAS 133 reflects the fact that both of these constituencies believe that economically valid hedging strategies that reduce cash flow risk inherently should not increase income statement volatility. Yet the existing standard often actually results in such transactions being recorded in a way that increases reported earnings volatility when in fact the economic substance is the opposite. There is an inherent problem when the accounting framework produces results that are the opposite of the economics of the underlying transactions, no matter how theoretically justified those principles or standards may appear.

Finally, because of the inherent complexity and subjectivity in certain accounting requirements (e.g., ARO liabilities, pension and PRB liabilities, long-term derivatives), any robust framework should consider whether investors and other financial statement users are better served by disclosure, rather than financial statement recognition, of such items. Many existing accounting standards incorporate the concept of measurement reliability as a condition for accounting recognition. We are not advocating disclosure as a substitute for proper accounting. Rather, we believe that the important concept of reliability should be considered and explicitly included in the development of a framework to support principles-based standards.

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**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?**

We believe that the FASB should further address issues related to interpretive and implementation guidance as part of the proposal. As noted, under a principles-based approach, the need for such guidance would be not eliminated, but reduced, requiring the use of professional judgment by preparers and auditors of financial statements. As part of the project, the standard-setting body that will provide such interpretive and implementation guidance should be clearly identified, whether it is the FASB, the EITF or another sub-body of the FASB, or public accounting firms. In our view, one body or group should be designated to provide this guidance for all standards. We believe that the FASB, or a sub-body thereof, should provide implementation guidance, in order to maintain the spirit of the consistent establishment of accounting standards by one standard-setting body. This would also ensure that the basis for conclusions or the "spirit" of the principle is maintained during the process of developing interpretive guidance.

As a part of the development of each principles-based standard, the Board should affirmatively determine whether implementation guidance is necessary. We believe that the instances in which such formal guidance is necessary should be relatively limited, and that when such guidance is provided, it should be of a broad, generic nature instead of a detailed, transaction-specific nature. The Board should also determine the forum through which such guidance is developed. While the necessity for timely guidance might make full due process, with exposure drafts and formal comment periods, impractical, we believe that such guidance should be developed and established in an open forum that encourages and welcomes public input, in a manner similar to how current EITF issues are discussed. This will allow for the clear communication of issues, specific examples of application and sharing of opinions between the FASB and those parties affected.

We believe that the FASB should also recognize and consider that, under a principles-based approach, public accounting firms may provide interpretive guidance to clients that may differ between accounting firms. This situation may result in differing accounting treatment for transactions based solely on differing accounting firm guidance, and the possibility of restatement of financial statements should the client change auditors. Diversity among accounting firms in interpretation might also lead to "opinion shopping."

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**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? If not, what needs to be done and by whom?**

All of the parties involved in the standard setting and financial reporting process would need to adjust their behaviors and processes in order for a principles-based approach to function properly. For example:

- **Standard setters** would have to resist the habits, pressures and tendencies for rules-based standards with bright line tests, etc., and would have to adjust to establishing standards that are based on economic substance and that allow the use of judgment in their application. In our view, rules-based standards are common in current US GAAP.
- **Preparers** would need to accept the responsibility for applying proper business judgment in complying with principles-based standards, and would need to resist the temptation to ask for cut-and-dried rules in order to reduce perceived risk.
- **Auditors** would need to accept diversity in practice, and would need to become comfortable with a “facts and circumstances-based” evaluation of clients’ accounting policies. The major accounting firms may need to increase staffing in their accounting research divisions in order to adequately respond to the demands of a principles-based approach.
- **Users** would need to understand that similar transactions might be accounted for differently, and would need to be comfortable with their responsibility to investigate more deeply the selection of, and basis for, accounting policies adopted by management under a principles-based approach.
- **Regulators**, such as the SEC, would need to avoid “second-guessing” management judgments based on the ultimate results of transactions – a good faith interpretation of principles and regulations should be viewed as adequate, regardless of the ultimate accuracy of the initial judgments. Further, regulators would need to avoid the temptation to “fill in the gaps” left by a principles-based approach through rules-based interpretations of standards. Because of the nature of their responsibilities, the

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adjustments required of regulators may be more significant than those of other stakeholders.

- Perhaps most importantly, the **legal environment** would need to accommodate the use of this approach to standard-setting. Laws and regulations would need to be adjusted such that plaintiff attorneys would not be in a position to engage in wanton litigation against companies, and their managements, purely based on the exercise of judgment necessitated by a principles-based approach.

EI believes that these are significant adjustments in existing behaviors and circumstances, and that these adjustments are absolutely critical to a successful change to a principles-based approach. FASB should carefully consider the likelihood for these adjustments before actively considering a change to a principles-based approach.

**5. What are the benefits and costs (including transition costs) of adopting a principles-based approach to U.S. standard setting? How might those benefits and costs be quantified?**

We believe that there are significant benefits to implementing a principles-based standard framework. As discussed above in "Support for a Principles-Based Approach," those benefits include:

- More transparent accounting that presents a more accurate reflection of the economics of the underlying business activities;
- Less opportunity for form-driven transactions that do not reflect the economics of the underlying transactions; and
- The facilitation of international accounting standards convergence.

These benefits are generally intangible in nature and are therefore difficult to quantify. However, the costs incurred by investment bankers and their clients in developing "financially engineered" transactions such as synthetic leases would largely be avoided under a principles-based approach, and this benefit, though not a comprehensive measurement, could be estimated.

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There are, however, significant costs related to implementing a principles-based approach - in addition to the costs acknowledged by FASB in its proposal. We believe that the following costs must be carefully considered:

- Implementation of a principles-based approach could require a complete rework of existing concepts and standards. This would likely be a very lengthy and costly process, requiring several years to complete.
- Financial statement auditors, regulators and analysts would likely incur greater costs in performing their functions under a principles-based approach, due to the diversity in practice that would be the likely result of such an approach. Instead of the broad application of "canned" conclusions to varying situations, each circumstance may require separate evaluation.
- The increased use of judgment implied by a principles-based approach could, unfortunately, expose preparers and auditors to increased litigation.

These potential costs should be more amenable to quantification than are the potential benefits.

The FASB should determine up front whether it would use a "prospective" or a "comprehensive" method to implement a principles-based approach. The former method would result in a more timely move to the new approach, but would result in inconsistent standards during the transition period. The latter method would be more time-consuming and potentially costly, but would result in an internally consistent and complete model upon implementation. If the comprehensive method is chosen, FASB should prioritize their standard revision efforts to first address those standards that are causing the most significant issues in practice.

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

In developing principles-based standards, a balance would need to be struck between theory and practicality. The principles-based standards developed would need to be supported by an adequate theoretical foundation, which would rely upon the FASB's Statements of Financial Accounting Concepts (which will likely need revision if principles-based standards are to be viable). At the same

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time, principles-based standards would have to be practical enough to lend themselves to ready implementation.

EI appreciates the opportunity to respond to the proposal for a principles-based approach to U.S. standard setting. We hope that our comments will be helpful and look forward to working with the Board in the future.

Sincerely,

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Business Operations

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