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**Proposal for a Principles-Based Approach to U.S. Standard Setting  
(File Reference No. 1125-001)**

Dear Ms. Bielstein:

We are pleased to provide the following comments on the Board's proposal to adopt a principles-based approach to U.S. standard setting. The comments expressed are similar to the views we expressed at the FASB's Roundtable on December 16 and the FASB/AAA Conference conducted in early December.

***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?***

We support the Board's efforts to reassess and improve its current approach to standard setting. However, we believe that the Board's proposal for a principles-based approach is ill-defined and, by itself, will not lead to an improvement in the quality of U.S. accounting standards. It is not entirely clear to us what the Board intends as the difference between "principles-based" standards and "rules-based" standards. We observe that *Webster's Dictionary* defines a *principle* as "a rule or standard, especially of good behavior." Some regard "principles" to be "rules" whereas others believe that "principles" refers to the overarching concepts that should be applied in establishing rules. In any event, accounting standards involve both principles and rules and the efforts to differentiate between the two perhaps are not that important to achieving the desired objectives of improving the quality and transparency of U.S. financial accounting and reporting.

We believe that much of the recent discussion pertaining to "rules-based" standards in the U.S. is the result of several well-publicized misapplications of the existing literature and the use of transactions designed to take advantage of the enormous complexity of today's accounting standards. However, we believe that the real issue concerning U.S. accounting standards is the lack of a consistent conceptual framework and improvements that need to be made to the standard setting process, including better drafting of the accounting standards themselves.

Instead of attempting to convert to a difficult to define "principles-based" approach, we believe that a better approach would be for the Board to first perform a comprehensive reevaluation of the conceptual framework. As discussed in the proposal, certain aspects of the current conceptual

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framework are incomplete, internally inconsistent, and ambiguous. We believe that reconciling the internal inconsistencies in the conceptual framework identified in the proposal would be a good place to start. Much of the current conceptual framework is simply a carryforward from concepts or standards initially developed by the Committee on Accounting Procedure and the Accounting Principles Board. Recent accounting standards tend to place an emphasis on asset and liability recognition whereas much of the current conceptual framework and older standards were written years ago with the emphasis being directed to the income statement. For example, the Board has long been aware that the “earning process” notion in the conceptual framework seemingly conflicts with an asset and liability approach to revenue recognition.

We also believe that the current “mixed attributes” model leads to confusing accounting outcomes and reduces the relevance of the financial statements. For example, certain items on the balance sheet are reported at fair value, such as derivatives, whereas other items, such as fixed-rate long-term debt, are not. And other items, such as rights and obligations under leases and other executory contracts, may not be recognized on the balance sheet at all. We believe that a comprehensive reevaluation of the conceptual framework in which inconsistencies are reconciled and “mixed attributes” are removed or minimized would result in clearer accounting standards that would be better understood, more easily applied, and less susceptible to financial engineering.

We support the concept discussed in the proposal that accounting standards should provide few, if any, exceptions. We agree with the proposal that much of the complexity in today’s accounting standards is the result of numerous exceptions to the general concepts provided in the standards. We acknowledge that many of these exceptions are provided for practicality reasons; however, the majority of exceptions appear to have been provided because the Board has accommodated a specific constituency or has narrowed the scope of a standard in order to provide more timely guidance.

We believe that significant improvements can be made to the standard-setting process notwithstanding a decision to adopt a “principles-based” approach. In particular, we believe that accounting standards should be reconciled to the applicable concepts in the conceptual framework. Standards should not attempt to create new concepts; rather those concepts should be embedded in the conceptual framework. We also believe that, even with this approach, there will be a need for implementation guidance and that the Board or its designee should be the provider of that guidance. In this regard, the Board should consider improving the examples provided in the standards. The inclusion of realistic examples that illustrate application of the standard in more difficult situations, as opposed to situations that are so extreme in their simplicity that the answer is obvious, will reduce the need for the significant amounts of post-issuance interpretive and implementation guidance that has become prevalent with recent standards. The examples also should provide a discussion as to how the result is consistent with the principles set out in the standard. We also suggest that the Board consider including examples that illustrate the application of the proposed standards in its exposure drafts so as to receive more meaningful comments from its constituents. Finally, no matter how principled the standard, how faithful it is to the conceptual framework, and how good the examples, implementation questions will arise.

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As such, we believe a formalized process to provide all constituents with FASB staff responses to questions received would further enhance the consistency of application of the standards and possibly highlight the need for clarifying amendments.

In short, we would recommend that the Board develop the following action plan to address these issues:

1. Develop a consistent and comprehensive conceptual framework
2. Identify inconsistencies in current accounting standards using that updated framework
3. Identify short-term improvements that may be made to existing standards to accelerate alignment with the conceptual framework – this step recognizes that a few basic changes may be made that would align accounting models more closely with the conceptual framework. This short term initiative follows the 80/20 rule in that making the last 20% of a standard theoretically pure will take 80% of the time. Instead, why not accomplish the fix of the major issues.
4. Develop a model for future standards that incorporates the above.

We would like to point out, however, that the Board's projects on revenue recognition and reporting financial performance provide the Board with an unusual opportunity to address the aforementioned inconsistencies in the Concept Statements and eliminate several major issues currently present in the mixed attribute model. We urge the Board to keep these projects on a high priority track with frequent communications and input from its constituents as it reaches decision points in this process.

We recognize that reevaluating the conceptual framework and making improvements to the standard setting process will be challenging and we believe that the Board should seek out the additional resources it needs to make the necessary changes.

***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?***

We do not believe that developing an overall reporting framework as in IAS 1, *Presentation in Financial Statements*, would be an efficient use of the Board's resources at this time. IAS 1 served an important purpose when it was originally developed in 1994 because the International Accounting Standards Committee was trying to establish an overall reporting framework that addressed divergent practices in many different countries.

We do not support the concept of a true and fair override and believe that it is unnecessary if accounting standards are properly written and applied. However, if the Board decides to include such an override as part of an overall reporting framework, we believe that it should be clearly

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defined and limited to only extremely rare circumstances, much like the similar guidance already included in Rule 203 of the AICPA Code of Professional Conduct.

***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 implementation guidance should be included in the accounting standards themselves and that if the standards are properly developed and consistent with the conceptual framework, the need for interpretive guidance will be minimized. If practice subsequent to issuance of an accounting standard identifies the need for interpretive guidance, then a process should exist in which the Board amends the standard, timely, to address the interpretive issues as opposed to allowing other standard-setting bodies, such as the EITF, the SEC staff, or de facto standard-setting organizations, such as industry groups or the accounting firms, to contribute to the current patchwork of accounting literature. We believe that the Board should be the primary standard-setter and that it should take responsibility to ensure the standards issued achieve the objectives set forth in the standards themselves. In this regard, we believe the EITF might be better utilized as a sounding board on the causes of implementation questions and/or diversity in application and recommended courses of action for the Board.

***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?***

We believe that the burden of improving U.S. standard setting lies with the Board. If the Board decides to make significant changes to the standard-setting process, we believe that such changes should be done using a measured approach over the course of several years, not overnight. For example, if the Board decides to reevaluate the conceptual framework and concludes that significant changes to the existing literature are necessary, then such changes should be phased-in over a period of years with the benefit of due process.

Even with the above transition, we believe changes in the way the financial community addresses accounting and reporting will be necessary. Financial statement preparers must be willing to interpret and apply the standards within the spirit of the rules and in a manner that best reflects the substance of the transaction and not just in the manner that produces the best results. Auditors must be willing to take a stand when they believe that their clients have not applied the standards in this manner. Regulators must be willing to accept that good faith efforts by companies and their auditors to apply the standards in this manner will result in some diversity in practice with respect to what, in hindsight, may seem to be similar facts or circumstances. And users have to make a better effort to understand accounting principles, including becoming more involved in the standard-setting process, and to have more realistic expectations with respect to reported earnings.

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***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?***

As discussed above, we believe that significant changes to the standard setting process will take time to accomplish and therefore any costs, including transition costs, will be borne over several years. We are not aware of any methods that could be used to quantify the benefits and costs associated with a change in the standard-setting process, but we strongly believe that clearer accounting standards that require less interpretation and that provide fewer exceptions will be easier to apply and thus lower the costs of preparing, auditing, and using financial information.

***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?***

We support the recent decision made by the Board and the International Accounting Standards Board (IASB) to formalize its commitment to the convergence of U.S. and international accounting standards. Accordingly, any significant changes to the Board's approach to standard setting should consider how such changes affect its commitment to convergence. We believe that if the Board undertakes a comprehensive reevaluation of the conceptual framework, it should attempt to do so with the involvement of the IASB. We believe that developing a consistent conceptual framework between the two standard setting organizations will best lead to higher quality convergence as opposed to the incremental approach to convergence such as the joint short-term convergence project to deal with specifically identified differences.

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We are available to discuss any aspect of our letter with Board members or the FASB staff.

Very truly yours,

*Ernst & Young LLP*