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From: Douglas.FLINT@hsbc.com [mailto:Douglas.FLINT@hsbc.com]
Sent: Monday, January 06, 2003 7:10 AM
To: director@fasb.org
Cc: russellpicot@hsbc.com; annaczarniecka@hsbc.com
Subject: Comments on Proposal for a Principles-based Approach to US Standard Setting - File Reference 1125-001

Letter of Comment No: 114
File Reference: 1125-001
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HSBC Holdings plc appreciates the opportunity to express our views on the proposal for a principles-based approach to US Standard Setting (File Reference 1125-001). In general, HSBC Holdings plc is in favour of a move to a more principles-based approach to standard setting in the US, although we are aware that such a move will present a number of implementation and transition issues. These issues will need to be addressed carefully before a principles-based approach to standard setting could be adopted. It is, however, our view that the costs involved in dealing with these transition issues would be justified by the benefits of this change of approach, not least the way in which this would facilitate convergence between US GAAP and International Financial Reporting Standards. The attached response addresses the issues on which comments have been specifically requested.

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(See attached file: US principles.doc)

HSBC Holdings plc: Response to FASB Proposal on 'Principles-based approach to U.S. standard setting': File Reference 1125-001

The board has specifically requested comments on the following questions:

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?*

HSBC believes that in contrast with principle-based GAAP, the current US 'rules based' GAAP creates certain issues:

- it results in accounting rules which are extremely complex. These rules are often difficult for preparers of financial statements to understand and apply. At the same time, these rules result in financial statements which are difficult for non-expert users of the accounts to understand, so reducing the relevance of the information provided;
- the implementation of new standards in response to emerging accounting issues can be severely delayed by the need to provide complex guidance and interpretation; and
- it creates the opportunity for financial engineering through the structuring of transactions to comply with accounting rules to produce a result which may not reflect the underlying substance of the transaction.

Under a principles-based approach, users of filings would be able to make economic decisions based on financial statements that recorded the economic substance of

transactions and would not be misled by transactions which had been engineered to meet accounting rules while not necessarily reflecting their true nature. It is therefore our view that the adoption of such an approach would improve the quality and transparency of US GAAP.

Adoption of a principles-based approach will align the underlying basis of US GAAP more closely with that used in IAS and so facilitate the process of convergence between these two bodies of GAAP. It should be noted, however, that IAS cannot be characterised as a wholly principles-based approach. IAS 39, in particular, contains significant rule-based elements, although these elements are in turn largely based on rules contained in US GAAP.

We have noted Attachment A to the proposal, which sets out a “principles-based” approach to certain aspects of Statement 133: *Accounting for Derivative Instruments and Hedging Activities*. While the “principles” described in this Attachment are certainly substantially shorter and simpler than the text of Statement 133 and its related implementation literature, it is important to note that these “principles” are in fact no less open to debate than are the rules of the current Statement 133. In particular, the statement in the second of the Attachment’s four “principles” that “Fair value is ... the only relevant measure for derivative instruments” is an assertion of a point of view and as such is in the nature of an accounting rule rather than an accepted and unchallenged accounting principle.

2. *Should the Board develop an overall reporting framework as in IAS1 and if so, should that framework include a true and fair override?*

The effective application of a principles-based approach will be easier if this is based on an overall reporting framework. Such a framework would provide a basis for assessing the approach to be taken for issues which are not addressed explicitly in principles-based standards. The conceptual framework adopted for this purpose should be as close as possible to that provided by IAS 1: Presentation of Financial Statements, as this will provide a conceptual basis for the convergence of US GAAP with IAS. The existence of an overall reporting framework will also allow a principles-based approach to be applied consistently between reporting entities and across industries.

In the UK, the ‘true and fair override’ option, whilst available to companies, is seldom used. Any inappropriate use of the override is quickly and effectively overturned, forcing the company to re-file.

As long as the US has an effective body to oversee such departures from GAAP, HSBC would welcome the introduction of the concept of a true and fair override into US GAAP. Such a concept would allow financial statements to reflect the substance of transactions in the rare cases where existing GAAP did not accommodate this.

The limited usage of the true and fair override in the UK may reflect the fact that UK standards embody a substance over form approach, so that the presentation of a true and fair view will only rarely require a departure from the requirements of UK accounting standards. It is HSBC’s view that a key principle, which should underlie all FASB standards, is that of accounting for the economic substance of transactions rather than their legal form.

3. *Under what circumstances should interpretative 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 guidance should be provided only in response to known abuses or to resolve cases where the accounting treatment of similar transactions shows significant divergence.

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?*

The adoption of a principles-based approach will place much more of the burden of interpretation of GAAP in the hands of preparers and auditors of financial statements. Effective implementation of a principles-based approach will depend on the extent to which preparers are willing to account for transactions in accordance with their economic substance and the extent to which auditors are willing and able to stand up to management who fail to apply a principles-based approach sufficiently robustly.

The willingness of management and auditors to account for transactions in accordance with their economic substance will be subject to the continuing pressure on entities to report higher levels of earnings.

HSBC believes that, at present, this pressure is offset by the current financial reporting climate, where preparers and auditors of financial statements have witnessed the implications of adopting accounting treatments which failed to portray fully the economic substance of transactions. In the longer term, however, it may be that such salutary examples will have a diminishing effectiveness in ensuring that preparers and auditors apply a principles-based approach in the way that is intended.

It would therefore be necessary for this market pressure to be supplemented by an effective set of controls and sanctions to demonstrate and enforce the adverse consequences of abuse or manipulation of a principles-based accounting framework. Such an approach will be preferable to the alternative, whereby a principles-based framework is supplemented and potentially swamped by supplementary rules issued, without due process by regulators, industry associations and other similar bodies.

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?*

Whilst there will obviously be some initial costs of adopting principles-based GAAP, it is our view that there would be greater benefits in the longer term.

The costs of adopting principles-based approach should not be under-estimated and will include, in particular, the need to revisit transactions whose treatment has been established under existing GAAP and to reconsider this treatment under a principles-based approach.

The benefits of a principles-based approach would take the form of:

- increased confidence from investors in US capital markets;
- reduced compliance costs for preparers and auditors of accounts;
- greater comparability between financial statements prepared under US GAAP and those prepared under IAS; and

- improved investor understanding of the basis on which US GAAP financial statements are prepared.

6. *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 would suggest that a proposal for the US to adopt a more principles-based approach to standard setting should explicitly consider the extent to which existing US GAAP should be re-written using principles-based approach. Using a principles-based approach for new standards only would create an unsustainable position where US GAAP is written on two distinct bases and, by leaving the existing complex structure of US GAAP unchanged, will mean that the complexity of the existing approach will remain largely unchanged.

HSBC Holdings plc
January 2003