

January 2, 2003

Ms. Suzanne Q. Bielstein
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

File Reference No. 1125-001

Re: Proposal on Principles-based approach to U.S. standard setting

Dear Ms. Bielstein:

We were encouraged to see the Board give consideration to a principles-based approach to standard setting as outlined in the proposal dated October 21, 2002. The past 18 months have seen an alarmingly high rate of restatements of financial results caused in many instances by an apparent misapplication of accounting principles. We believe the consideration of this proposal is an appropriate step in attempting to address the systemic issues in the standard-setting process that have contributed to some of these events.

We support the Board's proposal for a principles-based approach to U.S. standard setting (the Proposal) and we believe this could potentially result in an improvement in U.S. accounting standards and the practical application of those standards. However, we believe the transition to such an approach should be cautious and deliberate and should be done with a view towards establishing a workable middle-ground which moves away from the detailed rules-based approach but maintains an appropriate level of standards for today's complex business environment. Further, the establishment of the principles-based approach should give due consideration to a number of potential pitfalls that we will outline further in the comments to follow.

FIAC is a group of fifteen financial professionals working in executive level positions in the thrift and banking industries and is sponsored by the Financial Managers Society. FIAC's primary responsibility is to evaluate those accounting and regulatory matters that affect financial institutions.

Concerns with the Rules-Based Approach

We support the view that the level of complexity and detailed rules prevalent in accounting standards has, on balance, been detrimental to the standard-setting process. This is particularly true of more recent standard setting initiatives focused on complex transactions such as consolidation issues (SPEs, FAS 140 and related issues), and derivatives (FAS 133 and related changes and implementation issues). While attempting to close every possible loophole, very detailed standards have been established which essentially require a specific legal form to certain transactions. As noted in the Proposal, this focus on legal form and structure has resulted in extensive financial and accounting engineering focused on structuring transactions around the rules. The structures

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are focused on achieving a certain accounting treatment that is within the rules, but which often does not represent the true economic purpose and intent of the transaction.

The development of this type of standard-setting process is understandable given the desire for consistency in the application of standards among different business entities and the need to clarify the appropriate treatment for what are often very complex transactions. However, the exponential expansion of this rules-based approach has led to a lack of transparency and at times the illogical application of accounting rules to particular transactions.

The development of the rules-based approach to standard setting has also led to an unrealistic expectation of the standard-setting process. Financial statement preparers and public accountants have become too dependent on seeking a “cookbook” solution to accounting questions rather than assuming professional responsibility for making well-supported and documented decisions based on the economic substance of transactions.

As the standard-setting process attempts to develop a rule for every conceivable transaction, there are inevitably specific types of transactions that are not addressed in the standards and subsequently require extensive application guidance. This specific application guidance then results in further structural changes aimed at addressing the new rules; this repetitive cycle of rule setting and transaction structuring then continues. We believe this is a very inefficient method of standard-setting that results in accounting standards that are often one step behind innovations taking place in the business community. This process also discourages the rational application of accounting principles focused on the economic purpose and substance of transactions, as the legal form and its relationship to detailed rules become the framework upon which accounting judgments are made.

We note that one of the concerns with the rules-based approach raised in the Proposal is the difficulty for accounting professionals to stay current and that accounting standards are difficult and costly to apply. We would caution that we do not believe this would be a valid reason to move towards a principles-based approach. The application of accounting standards to sophisticated transactions will continue to be an often-difficult process requiring a thorough understanding of the accounting standards and a high level of professional expertise. The absence of a cookbook to refer to will result in the need to maintain more in-depth understanding of the underlying accounting concepts, and will result in a more extensive use of judgments in the determination of the appropriate accounting treatment. This concern should not deter us from a principles-based approach; however, companies sophisticated enough to initiate complex financial transactions should also be expected to invest in the resources enabling them to arrive at the appropriate accounting conclusion.

The Application of a Principles-Based Approach

While we support the concept of a principles-based approach, we recognize it does present a number of concerns. In addition, while we believe the rules-based approach has become overly complex, an overly simplified principles-based model could also potentially damage the quality of financial reporting. We cannot escape the reality of a complex business environment, and we should not seek accounting standards that overly simplify a complex world. Following is a summary of our concerns that should be addressed as the Board considers the development of a principles-based approach:

1. The conceptual framework- We agree a comprehensive review of the conceptual framework would be an essential starting point to a move towards a principles-based approach. We recognize many of the inconsistencies and ambiguities in the conceptual framework noted in the Proposal and agree these would need to be addressed. We also believe that as part of a project to improve the conceptual framework, the Board would need to carefully review existing standards and identify those standards, which contain

guidance, which deviate from the conceptual framework. Change to existing standards would need to be made to conform to a more comprehensive and complete conceptual framework.

We believe a consistent balance sheet focus is an important ingredient in the review of the conceptual framework. Standard setting initiatives of the last few years have tended to stray from the conceptual framework and the consistent application of accounting principles across industries when those principles have focused too extensively on the income statement impact of particular transactions. A consistently written set of principles focused on the recognition and measurement of assets and liabilities and the appropriate definition of those assets and liabilities will form the basis for a sound principles-based approach to standard setting.

2. Exceptions- We do not believe the elimination of all exceptions should be considered an essential element of a principles-based approach. There may be legitimate conceptually based exceptions to basic principles that should be considered on the basis of the reasons for the exceptions. We do not believe it is necessary to establish a blanket prohibition against all such exceptions.

Ultimately, the question of an exception will depend upon how the principle is defined. For example, we believe a measurement principle requiring the measurement of all assets and liabilities at their market or fair value with no exception permitted would not be an appropriate accounting principle. We believe it is appropriate to have differing basis for assets and liabilities depending on the reporting company's intention with respect to the disposition of that asset or liability, and we recognize that the ability to measure that asset or liability's fair value is also an important component of a measurement basis policy. An overriding policy to recognize all assets and liabilities at fair value without exception would not reflect the underlying economics of many transactions. The principles-based standards, although not as detailed and complex as our current rules-based approach, should allow for such deviations.

3. Interpretive and Implementation Guidance- We recognize the proliferation of interpretive and implementation guidance has contributed to much of the unnecessary detail in existing accounting rules and has greatly contributed to the current level of standards overload. An effectively developed set of principles-based accounting standards would serve to mitigate the extent of implementation guidance.

However, we believe there will continue to be the need for a standard-setting infrastructure, which can provide meaningful and timely implementation guidance when this is clearly necessary. A combination of both well-reasoned principles and thoughtful interpretative guidance are needed in today's accounting world to insure reliable, consistent financial reporting. The FASB, as the primary U.S. standard setter, should be fully-staffed and organized in a manner enabling it to continue to develop both principles and interpretive guidance in a complex financial environment.

4. A reporting framework - The body of existing GAAP could benefit from an overall reporting framework as in IAS 1 and would also represent an important element in moving towards convergence with IASB accounting and reporting standards. We also concur with the suggestion in the Proposal that a "true and fair view override" should be included in the overall-reporting framework. This would be consistent with a principles-based accounting approach focused on the economic substance of the business activity conducted.
5. Consistency- A potential divergence among companies in the application of accounting principles is one of our primary concerns as we consider the merits of a principles-based approach. The clarity and consistency of the established principles will be essential to the effective application of a principles-based approach. Without that clarity and a base level of implementation guidance, the consistency and reliability of financial reporting will be weakened. We will need to avoid a principles-based model that is overly broad and provides too much room for a variety of interpretations. We believe this can be achieved with a sound principles-based

approach, rather than through a detailed rules-based approach. A lack of clear well-defined accounting principles will lead to individual interpretation of principles by financial reporters and their auditors that will in turn destroy comparability of operating results between companies, even in the same industry.

6. **Professional and ethical standards-** Contributing to the financial reporting problems seen in the last 18 months has been degradation in the level of ethical standards to which some professionals hold themselves. A transition to a principles-based approach will not solve this problem and in fact will exacerbate the need for highly professional behavior on the part of CPA's both preparing and auditing financial statements. The professional environment must include clear, prompt and severe sanctions for those who fail to undertake and document a good faith attempt to appropriately apply the established accounting principles.
7. **A best-principles approach-**An unfortunate outgrowth of the rules-based approach has been the adoption of a mindset among some financial statement preparers that if there is not a specific rule prohibiting a desired accounting treatment, then by default the treatment is permissible. This approach has been applied in cases where the accounting principle has not been consistent with the underlying business purpose and intent of the transaction. For a principles based approach to work effectively, preparers and auditors will need to objectively adopt a philosophy of selecting the principle that best represents the economic substance of the transaction. In addition, the principles used and the rationale for the accounting treatment must be clearly disclosed in the financial statements.

Conclusion

We agree the problems of the past 18 months have highlighted some of the problems that can result from an extensive rules-based approach to standard setting. We also recognize that the current approach is a result of what the financial community has requested and note the comments of FASB Chairman Herz at a recent FEI conference: "the standards we currently have are largely a product of what people have asked for over the last 10 to 15 years in the context of the overall financial reporting, capital markets, regulatory and legal systems in this country".

We believe it is the appropriate time to take a step back and review where this direction has taken us and attempt to learn some valuable lessons from some of the problems that have transpired. While we believe we have the strongest, most thorough set of accounting standards in the world, we also believe that in many matters the quality of financial reporting has been damaged by the development of an extensive rules-based approach to standard setting.

We agree with the initiative the Board has begun through the issuing of the Proposal, and believe a move towards a more principles based approach will ultimately lead to higher quality, more meaningful, and more transparent financial reporting. However, the road to a principles based approach contains many potentially damaging potholes, and we need to move cautiously and give serious consideration to those concerns as we move ahead with this approach.

We thank you for your consideration of our views on this matter.

Sincerely,

Joseph Perillo
Chairman

cc: Ron Lott, Financial Accounting Standards Board
Halsey Bullen, Financial Accounting Standards Board
Zane Blackburn, Office of the Comptroller of the Currency
Gerald Edwards, Federal Reserve System
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