



Stephen F. Jablonsky Smeal College of Business Administration The Pennsylvania State University
214 Beam Business Administration Building
University Park, PA 16802-1912

Fax: (814) 863-8392
e-mail: jir@psu.edu

(814) 865-6473 Fax: (814) 863-8393

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Financial Accounting Standards Board

Comments on "Principles-based Approach to U.S. Standard Setting"

File Reference No. 1125-001

I welcome the opportunity to comment on a "Principles-based Approach to U.S. Standard Setting. Overall, I support a principles-based approach to standard setting. However, that support is based on making a set of interrelated changes to the entire standard setting process.

I have organized my comments by the six issues listed on pages 10 and 11 of the proposal.

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

As mentioned above, I support a principled-based approach to U.S. standard setting. My hope would be that a principles-based approach would improve the "quality" and "transparency" of U.S. financial accounting and reporting. However, "quality" and "transparency" are just buzz words like "convergence" and "visibility.' They add nothing to a discussion of a principles-based approach to standard setting.

The Board has identified the main reason that I support a principles-based approach to standard setting.

A principle concern is that accounting standards, while based on the conceptual framework, have become increasingly detailed and complex. Many assert that, as a result, it is difficult for accounting professionals to stay current and that accounting standards are difficult and costly to apply. Many also assert that because much of the detail and complexity in accounting standards results from rule-driven implementation guidance, the standards allow financial and accounting engineering to structure accounting transactions "around" the rules, thereby circumventing the intent and spirit of the standards. (p.2)

The second assertion is key to my support for a principles-based approach to standard setting — "the standards allow financial and accounting engineering to structure accounting transactions "around" the rules, thereby circumventing the intent and spirit of the standards."

If a principles-based approach to standard setting can minimize the amount of financial and accounting engineering that takes place, then all users of financial information will benefit. If the amount of financial engineering is not minimized, then a principles-based approach will be no better than the current standard setting process.

I would like to provide an example of how students (and faculty) develop a belief that accounting and auditing is concerned primarily with financial and accounting engineering.

A team of students from my university won the local case study competition sponsored by one the Big 4 (then Big 5) accounting firms. For the national competition, the team was given a case dealing with asset impairment of a mutual fund investment in U.S. Treasury bills. The client had dismissed the original auditors and the new auditors had to determine if the decline in the investment was "other than temporary" and when the decline in value should be reported in the financial statements. The client was a private company and was preparing to go public in the following year.

Without going into more of the details, the new auditors interpreted SEC Staff Accounting Bulletin (SAB 101) in way that would allow the client to recognize the asset impairment in a prior period (two years prior to be exact) and not have to include the loss on impairment in the income statements included with the IPO prospectus.

When I asked the students what they learned from the case presentation and subsequent presentation of the firm's solution, they answered, "Do whatever the client wants." The standards and rule-driven implementation guidance appear to be created to allow auditors to arrive at a solution that is acceptable to the client.

If a principles-based approach to standard setting minimizes this type of creative accounting, then all users of financial information will benefit. However, since a principles-based approach requires more professional judgment, the potential for accounting and financial engineering might actual increase. Hopefully, the provisions of the Sarbanes-Oxley Act will discourage these types of activities until a principles-based approach can be implemented.

The best way to minimize accounting and financial engineering is to remove the opportunities for those type of activities to flourish.

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

In the proposal, the Board has indicated that

In accounting standards developed under a principles-based approach, the principles reflecting the fundamental recognition, measurement, and reporting requirements of the standards would continue to be developed using the conceptual framework. (p. 5)

Given this commitment to the conceptual framework, it is not clear where an overall reporting framework would come into play. If an overall reporting framework were necessary, it would have to be developed after the conceptual framework has been revised, otherwise the overall reporting framework could not be based on the conceptual framework.

I will address the conceptual framework first and the overall reporting framework second.

Conceptual Framework

As mentioned by the Board, a revised conceptual framework needs to be complete, internally consistent, and clear. According to the Board, certain aspects of the current conceptual framework are incomplete, internally inconsistent, and ambiguous. The Board gives several examples of the problems with the current conceptual framework that need to be solved in order for it to serve as the foundation for principles-based standard setting.

To a certain extent, the current conceptual framework can be seen as the source of many of the current accounting and financial reporting controversies. For example, the definitions of "revenues" and "expenses" are not consistent with the definitions of "gains (losses)." For example,

Revenues are defined as increases in assets or decreases in liabilities during the period from delivering goods, rendering services, or other activities constituting the entity's major or central operations.

Gains (losses) are defined as increases (decreases) in equity from peripheral transaction of the entity excluding revenues (expenses) and investments by owners (distributions to owners).

To be consistent (and more conceptually correct) revenues (and expenses) should be defined to be consistent with the definition of gains (losses). For example,

Revenues are defined as increases in equity during the period from delivering goods, rendering services, or other activities constituting the entity's major or central operations.

Revenues should be defined in terms of what a firm gives or provides to customers that result in an increase in assets or decrease in liabilities.

A revised conceptual framework is a necessary first step in moving to a principles-based standard setting process. The definition of revenues is just another example of the internally inconsistent and ambiguous aspects of the framework.

## Overall Reporting Framework

According to the Board, the main objective of the overall reporting framework would be to provide guidance on issues such as:

- Materiality assessments
- Going-concern assessments
- Professional judgments
- Accounting policies
- Consistency
- · Presentation of comparative data

It also could include a true and fair view override to deal with extremely rare circumstances in which management concludes that compliance with an existing accounting standard would be so misleading that it would conflict with the objectives of financial accounting and reporting. (p. 7)

I believe that the issues raised by the board are appropriate for an overall reporting framework, but these issues are secondary issues. The primary purpose of the overall reporting framework should be to reaffirm the links between financial accounting and financial reporting. I believe that these links have been broken (or at least severely compromised) in the current financial reporting environment.

Prior to providing guidance on the issues mentioned above, the overall reporting framework should address the following issues:

 The financial statements presented in annual and quarterly reports articulate, i.e., the balance sheets, income statements, and cash flow statements are all based on the same detailed information included in the firm's financial database. The financial statements are based on three fundamental control equations;

Assets = Liabilities + Shareholders' Equity

Net Earned Assets = Net Income

Change in Cash = Cash Provided (Applied) by Operating, Investing,

## and Financing Activities

- Summaries for key accounts (Inventory, Receivables, Property and Equipment, etc.) should be
  provided in the footnotes that show all of the economic activity (beginning balance, additions,
  deductions, ending balance) for the period.
- The same type of analysis should be provided for all allowance accounts, valuation accounts, and reserve accounts that affect the determination of net income.
- In principle, readers of financial statements should be able to reconstruct an economic history of the firm (in summary form) based on the information presented in the financial statements and footnotes to the financial statements.
- If for some reason a "true and fair" override is appropriate, a detailed description of the override
  must be presented and the effects on the financial statements clearly stated.

A conceptual framework and overall reporting framework should be geared to the FASB's mission statement.

The FASB mission statement indicates that investment decisions rely heavily on credible, concise, and understandable financial information. Financial information cannot be useful to decision makers who cannot understand it, even though it may be otherwise relevant, reliable, and comparable.

The conceptual framework and the overall reporting framework must be designed to give reasonably informed users confidence that they can rely on the numbers reported in the financial statement.

3. Under what circumstances should interpretive and implementation guidance be provided under a principles-based approach to U.S. standard setting? If not, what needs to be done and by whom?

There will always be a need for some level of interpretive and implementation guidance. It is not so much a matter of who provides the guidance, but how that guidance is communicated to preparers, auditors, and users of financial statements. All guidance should be consistent with the issues and concerns surrounding the conceptual framework and overall reporting framework.

Preparers and auditors must indicate how the guidance received from the Board affects each financial statement and all accounts that support those financial statements.

The interpretive and implementation guidance provided by the Board should be reviewed periodically to insure that the guidance is not recreating the conditions for financial and accounting engineering.

4. Will prepares, 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 done and by whom?

The best way to address the "be able to adjust" issue is to look at the Sarbanes-Oxley Act for guidance. Everyone will adjust to the requirements of the law. The alternative to not adjusting is bleak. How can financial information be the "lifeblood" of U.S. capital markets if no one trusts the process by which that information is created?

If individuals do not adjust their behaviors to a principles-based approach to standard setting, we will have a problem equivalent to the "tragedy of the commons." Everyone will abuse the financial reporting process and there will be no credibility in financial information.

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?

The benefits of adopting a principles-based approach to standard setting have been discussed under the first two issues. The current crisis in accounting and financial reporting is somewhat like the Y2K problem. Collectively, U.S. companies had to spend billions of dollars to avoid a disaster.

If people think that the current system is beyond repair, then we have a Y2K problem. We must spend what we have to spend to fix the problem. If we do not have the equivalent to a Y2K problem, then the Board can choose to stay with the current system. The question then can be stated in the following manner:

- What are the benefits and costs (excluding transition costs since there is no transition) of staying
  with the same approach to U.S. standard setting? How might those benefits and costs be
  quantified?
- Do any short-term cost saving benefits outweigh the long-term costs associated with the loss of trust, credibility, and integrity?

If we consider the FASB and IASB as competitors in providing standards-based financial information to capital markets and that we could choose between the two, which Board would you chose? After teaching an international accounting course this Fall, the financial statements prepared under the International Accounting Standards were definitely more transparent and user friendly than the statements prepared under U.S. GAAP.

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?

In preparing to comment on this proposal, I consulted three popular textbooks on accounting and financial reporting to come up to speed on FASB-related topics. To my surprise, there was only a passing reference to the FASB and no discussion of the conceptual framework.

It would seem that the FASB and the current approach to standard setting are already being dismissed in large segments of the academic community. A principles-based approach to standard setting may provide a basis for making FASB-related materials more relevant to accounting students and faculty across the country.

In closing, I appreciate having the opportunity to comment on this proposal. After making my comments, I see that I am even more committed to supporting a principles-based approach to U.S. Standard Setting.

A number of my comments and suggestions are based on the way I teach accounting and financial reporting to undergraduate students and managers in executive education programs. Please feel free to look at the first five chapters of my book, *Management Communications: Integrating Strategy, Control, and Accountability*, if you are interested in the way I link financial accounting to financial reporting. These chapters are available on the web at <a href="http://www.personal.psu.edu/faculty/j/ii/jir/">https://www.personal.psu.edu/faculty/j/ii/jir/</a>.

Sincerely

Stephen F. Jablonsky