

Response to FASB (File reference 1125-001) "Proposal for A Principles-Based Approach to U. S. Standard Setting"

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Question 1

The "Proposal for a Principles-Based Approach to U.S. Standard Setting" is defective for two principal reasons: (1) it won't work and (2) even if it did work, the results would not be useful.

(1) Not feasible. The principles-based approach assumes management will behave in an ethical manner—that is, it will use methods that are in the best interest of society. This is not realistic.

A principle approach would be similar to scrapping all the existing rules about vehicular traffic, and replacing them with the principle that drivers should not use excess speed. This would eliminate the rules for left turns, red lights, yellow lights, green lights, yield to pedestrians, using directional signals, railroad crossings, passing another car, using high and low headlight beams, following a fire truck, multi-lane highways, hills, curves, residential areas, encountering a work site, intersections, schools, stopping for a school bus, commuter lanes, not tailgating, driver who has had too much alcohol or drugs, driving in snow or rain, child restraints, and emergency vehicles. Lawyers would have a great opportunity of interpreting the principle in a specific situation. It would eventually result in a set of common laws comparable to the present rules.

A principle in financial accounting is that revenue is recognized in the period in which goods and services are delivered and in the amount received or expected to be received. Companies may have different opinions about recognizing leases with various qualifications or paying for purchases over various time qualifications. Real estate developers differ as to the timing of revenues and costs for various stages of a project and about payments on borrowed funds or equities. Companies with oil or other mineral deposits differ about how and when they recognize revenue. Companies also differ with revenues from research or partially developed research projects. Construction companies differ with the timing of revenue recognition of various stages of a project. Motion picture producers may not know the revenue for a film until well after the year has ended and software producers whose revenue is derived from license agreements may not know revenues until after the period has ended.

Another illustration relates to a revision of Statement 34, which deals with the recognition of equity interest as a cost. The proposal does not shorten the existing text. Rather, it suggests additions that deal with specific topics related to equity interest.

Presumably the new principles would be similar to IAS 1, but this standard is by no means a clear statement of principles. It contains references to IAS 2, IAS 5, IAS 7,

IAS 8, IAS 13, IAS 16, and IAS 30. There is no distinction between statements in Statement One and statements in these other seven statements.

The new principles probably would be shorter than the existing standards, but the existing standards could be shortened considerably by using up-to-date methods, as described below.

(2) Not practical. Even if a workable concept could be defined, its resulting information would not be useful because the amounts listed for various items would depend on the preferences of the preparers. Even if preparers were equally ethical and knowledgeable, they would invariably reach different conclusions about certain transactions. The resulting numbers therefore, would not be comparable.

Question 2

The board should develop an overall framework. It should start with a new category on “general standards.” This would include, conservatism, assets = liabilities + equities, only monetary amounts, entity concept, going-concern, fair value if available, all materiality, realization, matching, four sets of financial statements and other general information now included as concepts. The standards should be arranged in six categories: general, revenue, expense, asset, liability and equity.

If a transaction involves two categories such as revenue and asset, the rule should be listed under the revenue category and cross-referenced under the other category. Similarly, if the transaction involves expense it should be listed under the expense category.

Edit existing standards; remove explanations, examples, reasons and other sentences that do not state what the standard is.

Statement 133 has over 100 statements about derivatives, and another group called Derivative Implementation Group has almost 100 more. Some of these comments duplicate or overlap others. Nevertheless the results are complicated statements and the FASB should not avoid making the necessary decisions.

This approach is covered in my book *Rethinking the Rules of Financial Accounting* published this year by McGraw-Hill.

Question 3

The word “guidance” is vague. There is either a rule that specifies what should be done, or what should be done is left to the judgement of the preparer. The “interpretive and implementation guidance” are either part of the rules or non-existent.

Question 4

The principles-based approach is not useful to anyone for reasons given in Question 1.

Question 5

The benefits are non-existent, so the comparison of costs and benefits is not necessary.

Question 6

The board should not adopt a principles-based approach, but it should modify its existing standards along the lines stated in Question 2.

Statement 133

The proposal uses Statement 133 as the only example of a principles-based approach. (Statement 34, which is given as another example, is not actually relevant, as explained below.)

The proposal does not give an example of the revised material about *Derivative Instruments and Hedging Activities*. The closest it comes to it is described in the text according to four principles: (a) rights to obligations that are in fact assets, (b) fair value is the relevant measure, (d) hedged items should be defined. (Item c is not used here because it is an obvious statement.) These should be stated as standards.

Statement 34

The proposed revision of Statement 34 is based on the conclusion therein that equity interest on borrowed funds is treated as a cost. As the explanation accompanying this statement says, many people believe equity interest is a cost that should be recognized in accounting. The basis of conclusion stated that some board members believe recognition of equity interest should be recognized some time in the future. I agree with this recommendation. Because the proposed change in Statement 34 gives no recognition to this possibility, I do not comment further on it. It is another attempt to avoid what I believe is a sound rule.