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Certified Management Accountant Program Certified in Financial Management Program

December 4, 2002

Ms. Suzanne Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Letter of Comment No. 39 File Reference: 1125-001 Date Received: /2/5/62

Re: File Reference No. 1125-001

Dear Ms. Bielstein,

The Financial Reporting Committee (FRC) of the Institute of Management Accountants appreciates the opportunity to provide its views on the document Principles-Based Approach to U.S. Standard Setting. The FRC supports a move towards a principles-based approach to standard setting but disagrees with some presumptions underlying the proposal. We believe that principles-based standards should improve financial reporting by changing the rule-based mentality that has contributed to the current crisis of confidence in the capital markets. In addition, changing the paradigm of standard setting to focus on principles should help curb the enormous growth in the accounting literature that has occurred over the past decade - growth that has created a labyrinth of requirements that are difficult for many accountants to navigate and comprehend. We strongly agree that authoritative guidance cannot continue to expand at its present pace unabated. However, we do not concur with the Board's presumptions that few or no exceptions to principles and increased earnings volatility are necessary consequences of a principles-based approach. In addition, we believe that as the Board pursues this objective, it must consider ways in which structural impediments to principles-based standards can be overcome and develop a resolution process for differences in application. We will find ourselves in a demonstrably worse position if these new principles-based standards are "supplemented" on an ad-hoc basis by detailed requirements and prohibitions promulgated by others outside of the Board's robust due process. Our detailed comments follow.

## Principles vs. Rules

Our Committee spent a considerable amount of time discussing the difference between principles and rules. We concluded that the primary difference was that principles had more of a concept

underlying them compared with rules, but that it was often difficult to clearly differentiate between the two. For example, we noted that some constituents believed that requiring a specific attribution method for pension cost was a rule while others believed it was a principle. The FRC believes that regardless of what label you attach to it, this type of requirement is an essential part of the standard and that comparability of financial statements would suffer if it were excluded from the standard on the basis that it was not a principle. We therefore concluded that what the Board really intends to accomplish with this approach is the development of standards with clear principles supplemented with the right level of application guidance (which some may conclude are "rules") to ensure comparability and enhance understanding of key requirements of the standard. The success or failure of this approach will depend in large part on:

- (1) appropriateness of the principles selected
- (2) clarity and operationality of the principles
- (3) inclusion of the right amount of application guidance
- (4) consistency of the principles in the standard with other related guidance
- (5) effectiveness of the process for resolving practice issues

## Structural Impediments to Principles-Based Standards

The FRC observes that there are several key factors that have contributed to the proliferation of detailed rules that we have today. Each of them needs to be considered and addressed by the FASB, the SEC and Congress, as appropriate, to enable implementation of the new approach.

- 1. The desire (some would say need) for companies and their auditors to protect themselves from trial lawyers that claim misapplication of accounting whenever there is a financial reporting event that precipitates a steep decline in a company's share price. Whether it is true or not, the attorneys who defend against such suits and their clients believe that it is easier to defend the company's accounting and the auditor's performance of its responsibility when there are detailed rules against which to assess compliance.
- 2. Concerns about having accounting practices overturned by the SEC Staff (which often exposes companies and auditors to the litigation described above, whether justified or not) coupled with the Staff's insistence that there can be only one method of applying an accounting principle for a particular class of transactions or activities. In our experience, there has been an increase in the discomfort at the SEC with differences in transaction structures and terms that could and, in our opinion, should result in different accounting for different transactions within a given class. In the present environment, political pressure coupled with toxic levels of cynicism in the news media (most of whom have only a superficial understanding of accounting), appear to be pushing the Staff and the Commission in the opposite direction from what is necessary to support a principles-based approach.
- 3. The transformation of standards setting from a part-time activity, staffed primarily with volunteers, to a full-time Board with a dedicated staff (with support from AcSEC and EITF) has provided the resources to respond generously to our desire for accounting certainty in the form of detailed rules. Historically, when changes in basic principles have been deemed necessary, (e.g., the change from the deferred method to the asset and liability approach to accounting for income

taxes), the new standard proved to be significantly more complex and detailed than the old one. The composition of FAS 133 bears witness to the difficulties and limitations associated with detailed standards.

The FRC observes that any attempt to promote principles-based accounting standards ultimately will fail unless something is done to address factors 1 and 2. Although factor 1 is not within the Board's purview to address, we believe that these issues should be highlighted in the report to Congress in compliance with the mandate in the Sarbanes-Oxley Act. Factor 2 could be resolved through the resolution process we describe later in this letter. Factor 3 is a function of process and is largely within the control of the FASB and its standard-setting partners to remedy. We offer suggestions on process improvements later in this letter.

## Implications of Principles-Based Standards

The proposal broadly defines "principles-based standards" as guidance in the form of accounting concepts with few, if any, exceptions and less interpretive guidance. While we agree with the latter conclusion, we believe that the absence of exceptions is not a necessary consequence of a principles-based approach.

As practitioners, we believe that the concepts in a proposed standard should apply only to the categories of transactions for which the accounting makes sense, which may require scope exceptions depending on how the principles are developed. We do not believe that applying broadbased concepts to inappropriate categories in the name of simplicity will improve the relevance of financial reporting. If we were not to identify exceptions, where appropriate, the effect on financial reporting could be fairly dramatic.

Take for example, the staff's analysis of how FAS 133 would have been affected by a principlesbased approach. According to the analysis, scope exceptions such as those for normal purchases and sales and for certain types of embedded derivatives, among others, would be eliminated in the name of simplification. We wish to make it clear that those exceptions were implemented to ameliorate the effects of a more fundamental problem with the standard: the definition of a derivative is so expansive that even commonplace contracts executed in the ordinary course of business would otherwise be considered derivatives. This problem is compounded by the extraordinary complexity of the requirements, which eclipse the ability of many (if not most) accountants to comprehend them. Eliminating those scope exceptions in the name of simplification achieves precisely the opposite of the desired objective for including them. It will force purchasing managers and others to have to gather data and perform analyses for purposes of applying FAS 133's provisions to their normal purchase arrangements (e.g., commodity and power) at considerable cost and for little or no improvement in financial reporting. Subjecting ordinary course of business inventory purchases to FAS 133 should not be mistaken as an improvement in the standard. We urge the Board to reconsider its presumption that exceptions are a major source of the problem. We would suggest that the need for them should serve as a warning that the principles in the standard may need to be reexamined. If used appropriately, we believe that exceptions are essential to ensuring that new accounting standards are applied only in the circumstances where that accounting makes sense and would improve financial reporting.

The proposal also states the Board's view that fewer exceptions to principles will lead to increased volatility of reported earnings. While we acknowledge that, all other things being equal, that conclusion is undoubtedly the case, we question the premise that principles themselves should automatically result in greater volatility. At the heart of this debate is the issue of when fair value is appropriate as the primary measurement attribute and, importantly, when changes in fair value should be reflected in earnings. We continue to struggle with this issue and have no easy solutions or persuasive arguments to offer. However, we do observe that EITF Issue 98-10 suggests a need for caution. Mark-to-market accounting for energy contracts required under that consensus proved to be extremely problematic in practice and ultimately led the Task Force to rescind it this past October. This experience underscores the concerns we have with fair value measurements that produce instant earnings and the need for the Board to give careful consideration to the implications and consequences of future steps in this direction. In the present environment, where an error of a penny per share is considered material and CFO's and CEO's are being asked to certify that their company's financial statements are accurate under the threat of criminal and civil penalties, the debate between relevance and reliability has taken on an important new dimension. The FASB must consider the significant implications for this group of constituents as it reaches conclusions.

In a similar vein, there is a widely held belief that the Board focuses almost exclusively on balance sheet measurements in developing new standards, and that earnings are "whatever is leftover." The Board's early deliberations on its revenue recognition project demonstrate this tendency. We believe that the Board should carefully consider the effects of new principles on both earnings and financial position. The Board should not automatically select the answer that gives the best balance sheet answer (however that is determined), nor should it automatically defer to the income statement. It needs to carefully weigh the effects on both statements and develop the best overall position. For example, the current debate over pension accounting seems to suggest that pension cost would somehow be more meaningful if only gains and losses on pension assets were reflected in current earnings. But pensions are a long term cost of the company that require the selection of an actuarial cost method as well as many other assumptions such as employee working periods, expected lives of pensioners, discount rates, etc. We simply don't understand how a pure asset/liability approach to this issue would make more sense for users of financial reports. Indeed, the FASB acknowledged this issue in paragraph 175 of FAS 87, which states, in part:

"However, in the case of pension liabilities, volatility may not be entirely a faithful representation of changes in the status of the obligation (the phenomenon represented). It may also reflect an unavoidable inability to predict accurately the future events that are anticipated in making period-to-period measurements. That is, the difference in periodic measures of the pension liability (and therefore the funded status of the plan) results partly from the inability to predict accurately for a period (or over several periods) compensation levels, length of employee service, mortality, retirement ages, and other pertinent events. As a result, actual experience often differs significantly from that which was estimated and that leads to changes in the estimates themselves. Recognizing the effects of revisions in estimates in full in the period in which they occur may result in volatility of the reported amounts that does not reflect actual changes in the funded status of the plan in that period."

We have to get beyond the initial allure of this kind of volatility as some form of irrefutable evidence of accounting truth and ask ourselves what it adds to the usefulness of financial statements. Perhaps when the benefits to investors are better articulated we will change our view,

but we are not optimistic.

The issues discussed above underscore the importance of the Board's project on performance reporting. We are not suggesting that that project will somehow cure all of the underlying problems, but it is clear that the Board needs a framework for what earnings should represent as it considers new accounting standards.

The proposal also indicates that a true and fair override notion may be considered as a necessary complement to principles based standards. The FRC does not support such a change. We observe that US GAAP already has such a requirement in Rule 203 of the AICPA's code of ethics. In its entire history, this rule has been invoked a half dozen or so times and not at all in the past 20 years. If standards are truly principles-based, there will be the need for a reasonable amount of professional judgment in their interpretation and application. A further true and fair override would seem to only introduce the possibility of mischief.

The proposal also states that broad principles would result in standards that would be easier to understand and easier to implement. The FRC notes that implementation is often aided by Q&A documents, EITF guidance, and through other sources. We believe that implementation would probably be harder in most cases but that is a price that we should be willing to pay for more general standards that would permit more judgment. We also reiterate our view that implementation would be even more difficult if it were not for exceptions.

## The Path to Principles-Based Standards

As much as we would like to see improvements in complex standards like FAS 133 and FAS 140, the FRC does not recommend that the Board undertake a "backward-looking" project at this time to try to rewrite those standards in a way that minimizes exceptions and implementation guidance. We believe that a principles-based approach will, of necessity, involve new processes and a steep learning curve. Accordingly, we would think that these would not be the standards that the Board should use as guinea pigs. Since the IASB is committed to promulgating principles-based standards, it would seem appropriate to use convergence initiatives as the laboratory for this endeavor. As convergence projects are undertaken, the FRC would support process changes at the FASB so that:

- (1) conflicts in the literature and major practice issues are identified during the pre-exposure draft phase, and
- (2) those discoveries are used to test and refine the basic concepts of the proposed standard before it is exposed for comment.

We believe that those process changes would reduce the need for exceptions and implementation guidance by clarifying deficiencies in the working principles. Many scope exceptions and special rules are granted late in the process because unintended consequences of the proposal are identified during the exposure period, and the FASB decides not to reconsider the basic principle. Involving more outsiders in the development of exposure drafts (including field testing) would identify such issues sooner in the process and presumably reduce exceptions granted for that reason. The project team should – at a minimum – test its preliminary conclusions against transactions already identified in EITF issues and staff technical inquiries. The FRC believes that this should be the

model for all future standards that are set.

The FRC also believes that FASB standards and interpretive guidance could be written and published in a more accessible manner. The FASB has identified "Other Simplification and Codification Initiatives" that include some minor changes in the way standards are written. There is significant room for improvement in this area and a greater reduction in complexity would be achieved if the Board focused its resources on publishing existing standards and related interpretive guidance differently. Specifically, a practitioner should not have to read through numerous pronouncements to understand the accounting for a single transaction. Currently, when the FASB issues interpretations and implementation guidance (primarily EITF issues, staff announcements, Q&A's, DIG), it integrates Board-level decisions and lists (title only) staff-level guidance in the Current Text once a year. A practitioner must first identify staff-level interpretations and then read them in full to understand how they fit into the basic principle. The FRC believes that the FASB should integrate every interpretive conclusion into the body of the existing standards (in a narrative fashion, like the Current Text) as part of issuing a pronouncement of any kind (i.e., concurrently – not once a year). We believe that this would ensure that the Board would:

- 1. State the primary principle more clearly and revise it over time, if necessary
- 2. Identify conflicts in the literature as part of field work
- 3. Be conscious of the growing length and complexity of certain areas of the literature, and
- 4. Provide more concise, retrievable standards.

A couple of small examples help illustrate this point:

- After FAS 133 was issued, a scope conflict was identified between FAS 133 guidance on
  embedded derivatives and APB 14 on convertible debt. If the project team were responsible
  for integrating their standard into the body of the literature it would have been caught during
  the development of the standard. Instead, we have a separate 2-page EITF issue that
  practitioners must find and comprehend to determine which standard applies to convertible
  debt (Issue 99-1).
- The conclusions in EITF Topic D-99, a FASB staff announcement on various types of servicing activities, can be summarized in about eight points. Currently, a practitioner has to find Topic D-99 and read 5 pages to ensure that the implications of servicing activities have been properly considered. Including those eight points in the Current Text (or something like it) would simplify the overall accounting model.

We also believe that the Board should consider the process for resolving differences in application. Our preliminary thinking is that the EITF Agenda Committee would be the appropriate gatekeeper, particularly in light of the changes the FASB has made to its relationship with the Task Force. In our view, the Agenda Committee would make one of three decisions on any given difference in the application of a principle that is brought to its attention: (1) conclude that having a difference is acceptable, (2) refer the issue to the FASB, or (3) ask the EITF to address it. While this role for Agenda Committee is not dramatically different from its present responsibilities, the volume of issues under a principles-based approach could expand significantly from what it is today. The

Board may wish to think through the process and resource needs, as decisions about which differences in application are permissible are likely to be incredibly time-consuming and could undermine the goal of the effort.

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The Board observes that all participants must be equally committed to making changes in their approach to their roles in order for a principles-based approach to work. We strongly agree and offer our commitment to work with other stakeholders to find ways to make this change possible. If you have questions regarding this letter, please feel free to contact me at (203) 373-3563.

Sincerely,

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Mitchell A. Danaher Chair, Financial Reporting Committee Institute of Management Accountants