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Ms. Suzanne Q. Bielstein
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Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Ms. Bielstein:

**FASB *Proposal for a Principles-Based Approach to U.S. Standard Setting* (File Reference 1125-001)**

We support the Board's effort to develop a principles-based approach to standard setting as addressed in the *Proposal for a Principles-Based Approach to U.S. Standard Setting* (the Proposal). However, we have a fundamental concern with the Proposal because it does not define a principles-based standard. If the FASB moves to a principles-based approach, the definition would be a critical attribute against which to assess whether a proposed standard meets the definition and evaluate whether the approach is working.

A principles-based approach would enhance the quality and transparency of U.S. financial accounting and reporting only if the principles are clear and intuitive, and preparers and auditors can readily apply the principles. It is not clear to us whether principles-based standards are inherently simpler than rules-based standards; however, it is clear that while the transactions they address may be complex, the final product of a principles-based approach needs to be intuitive to achieve consistency in compliance and to provide useful information to analysts and other users.

It is our belief that principles-based standards should have fewer bright lines than rules-based standards, and should result in recognition and measurement of the substance of a transaction not its form. To facilitate applying the standards, we believe that principles-based standards should include implementation guidance and examples within the body of the standards to provide preparers, auditors, and others with a better understanding of the Board's principles. Stated in a different way, the Board should define the content of a principles-based standard to include initial implementation guidance and examples. Finally, disclosures that focus on the economic substance of a transaction or event are an integral part of a principles-based approach. Presumably the disclosure requirements under a principles-based approach would be more general than the requirements that exist today, and would focus broadly on the accounting policies selected by the preparers, professional judgments, and assumptions that have a material effect on the financial statements.

While we favor the move to principles-based standards, that move would require diverting significant Board and staff resources from initiatives that arguably are equally important or perhaps more important, for example, the need for better financial performance indicators, and valuation and disclosure of intangible assets. We recognize that external pressures are driving the Board to consider the issues related to principles-based standards at this time. Thus, the remainder of this letter addresses our views on the specific questions that the Board identified in the Proposal on the premise that the Board will proceed with this effort.

**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?**

Yes, we support a principles-based approach to U.S. standard setting. However, as stated above, we are concerned because the Proposal does not define a principles-based standard. We are concerned that support is building for a concept that means different things to different people. Does the Board believe that principles-based standards mean less complex standards? Less cumbersome standards? Fewer bright lines? Substance over form? The Proposal hints at all of those attributes, but stops short of answering this threshold question. Our answer is provided in our introductory comments.

***Broad Principles with Few Exceptions***

The Proposal states that the first of two main differences between accounting standards developed under a principles-based approach and existing accounting standards is that the principles would apply more broadly than under existing standards and, therefore, provide few, if any, exceptions to the principles. However, we note that page 7 of the Proposal states, "The Board acknowledges that, as a practical matter, it might not be possible to eliminate all scope and transition exceptions." We agree with the Board's assessment that fewer exceptions are fundamental to a principles-based approach, and urge the Board to articulate early in the process what types of scope and transition exceptions the approach would permit.

***Relationship to the Conceptual Framework***

In a discussion of the relationship between a principles-based approach and the FASB's conceptual framework the Proposal states:

> Accounting standards with principles that apply more broadly than under existing accounting standards would require a conceptual framework that is complete, internally consistent, and clear. Thus, the Board would need to commit resources to a project to improve the conceptual framework.

We believe that a principles-based approach would make the concepts statements more directly valuable to preparers, auditors, and users as guidance in applying principles-based standards, rather than just a tool for the Board to use in developing standards. Thus, we agree with the Board's assessment that it would need to commit resources to a project to improve the conceptual framework. Generally, in practice the concepts statements are used infrequently to resolve accounting issues today. In contrast, under a principles-based approach, preparers, users, auditors and regulators would have to understand the framework and its elements and definitions to be able to apply the principles to a specific fact pattern.

The Board may need to clarify the role and authority of the concepts statements in conjunction with adopting a principles-based approach. We believe that the Board could effectively argue that the concepts statements should become a part of Category A GAAP in the GAAP hierarchy. A collateral issue is that the hierarchy of GAAP is set forth in an auditing standard that is applicable to members of the profession. The GAAP hierarchy should be part of GAAP and supported by the GAAP standard setters.

Finally, in a principles-based standard-setting environment, the Board may need to consider whether it should address principles for a broad topical area (for example, financial instruments) before it sets further standards to address specific types of financial instruments (for example, instruments with characteristics of both liabilities and equity). Stated another way, constituents may find it easier to apply an individual principles-based standard if the Board first articulates a broad set of principles derived from the concepts statements. One of the reasons for the significant implementation issues related to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is that the Board issued the standard before it resolved certain underlying principles for financial instruments, like distinguishing between liabilities and equity and when to separate versus combine components of a contract for accounting purposes.

**Should the Board develop an overall reporting framework as in IAS 1 and, if so, should that framework include a true and fair view override?**

We do not believe that the Board separately needs to develop an overall reporting framework. There appears to be overlap between some of the material in International Accounting Standard No. 1, *Presentation of Financial Statements*, and the issues that the Board is addressing in its project on reporting financial performance of business enterprises. Other issues, for example, offsetting of assets and liabilities, are addressed in FASB standards. Still other issues, for example, purpose and components of financial statements, are addressed in the concepts statements. Because U.S. GAAP is considerably more developed today than international accounting standards were when IAS 1 was written, it is not clear to us whether developing an overall reporting framework similar to IAS 1 passes a cost-benefit test.

We believe that financial statements that present a true and fair view should be the natural outcome of applying principles-based standards. Stated another way, the true and fair view is embedded in standards that are established under a principles-based approach because the object is for preparers to apply the principles in a manner that reflects the economic substance of the transaction. An explicit true and fair view override seems redundant with that objective.

**Under what circumstances should interpretive 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?**

The second major difference that the Proposal identifies between accounting standards developed under a principles-based approach and existing accounting standards is that under a principles-based approach there would be less interpretive and implementation guidance (from all sources, not just the FASB) for applying the standards. As stated earlier in our letter, we believe that implementation guidance will be as necessary under principles-based standards as it is under rule-based standards. Implementation guidance that helps preparers and auditors account for similar transactions similarly is useful and necessary to achieve comparability of reported results. We acknowledge that implementation guidance that creates exceptions to the principles causes practice problems and would be inconsistent with a principles-based approach.

We believe that initial implementation guidance including examples needs to be part of the standard, not a follow-on effort. Writing implementation guidance as part of the development of a standard is a good test of whether the standard is practicable. If the Board cannot take a standard and apply it to some common examples, it cannot reasonably expect others to do so effectively. That test of practicability is very important in a principles-based environment. Thus, we believe that a move toward principles-based standards provides a natural opportunity for the Board to reevaluate the nature and content of the implementation guidance that it currently provides.

Finally, under a principles-based approach, it will be critical for the FASB to better use the practical experience of subject matter experts, and to allow those individuals to be more involved in the development of the principles-based standards. One way to do that would be for the FASB to expand broadly its use of task forces that comprise subject matter experts.

**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?**

Under the current rules-based approach, when transactions test the "letter of the law," standard-setters are asked to clarify the concept that underlies the standard, that is, the so-called "spirit of the law." In contrast, we believe that principles-based standards appropriately allow preparers, auditors, and users, rather than financial engineers, to interpret the standard and apply judgment about whether a transaction is being structured to achieve a stated accounting answer that is not in accordance with its substance.

Hopefully, with well-articulated principles and appropriate implementation guidance that is incorporated into the body of the standards, the result will be improved financial reporting.

We are prepared to accept the differences that will arise in interpretation of standards, and are prepared to make the good-faith judgments necessary to apply principles-based standards knowing there is the possibility that those judgments will be questioned. However, we believe that a principles-based system will succeed only if the regulators and others make a similar commitment to accepting those judgments. If the plaintiffs' bar starts a new wave of litigation against preparers and auditors on good faith judgments made in preparing and auditing financial statements, we would expect the pendulum to swing back toward demand for more rules-based standards. Auditors and preparers will not embrace principles-based standards for long in the face of increased litigation or regulator action.

The Proposal may underestimate the effect of environmental differences that will distinguish between the IASB's success in moving toward principles-based standards that will be applied in countries that are not as litigious as the United States, and the FASB's success in mirroring the IASB's lead. We believe that this environmental distinction is largely overlooked, but, if unchecked, it will be a key driver in moving preparers and auditors away from principles-based standards.

**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 Board's discussion in the "Benefits and Costs" section of the Proposal appropriately identifies as benefits of a principles-based approach the increased comparability that results from fewer exceptions and the increased focus on the economic substance of the transactions as a result of increased application of professional judgment in applying standards. We agree with the Board's conclusion that if other participants in the U.S. financial accounting and reporting process make the changes required under a principles-based approach, the benefits of adopting that approach would outweigh its costs.

**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?**

A significant factor about which the Proposal is silent is how the Board would transition to principles-based standards. What happens to existing standards that are deemed not to be principles-based or that are inconsistent with principles established in new standards that the Board issues under the approach? For example, in general, many recent standards have had a balance sheet-fair value focus. Even if the Board were to review FASB Statement No. 87, *Employers' Accounting for Pensions*, with a view to making it more principles based, the Statement has an income statement focus, which is inconsistent with the current direction of the FASB. How would the Board expect to resolve that conflict? Stated another way, under a principles-based approach, does the entire set of GAAP need to be revised, rather than creating one new standard at a time? It is not clear that wholesale change would be the best use of the Board's resources or that it would improve confidence in our financial reporting system. Rather, an articulated plan to address nonconforming standards would be a more rational approach for the U.S. markets.

We have identified the following other factors that the Board should consider in assessing the extent to which it should adopt a principles-based approach to U.S. standard setting:

- How, if at all, do assessments of *materiality* and *cost-benefit* change under principles-based standards?

- At what level does the Board expect to achieve (or believe that it is appropriate to achieve) international convergence, at a principles level or at a more detailed level?

- We disagree with the Board about the level of detail that a principles-based version of FASB Statement No. 34, *Capitalization of Interest Cost*, would include. We believe that the exercise of rewriting Statement 34 might have been more enlightening if the Board had started with a "clean sheet of paper" rather than excerpting from the existing standard. We urge the Board to continue the process of selective rewrites of existing standards as it continues to explore principles-based standards.

- The discussion in Attachment A of the Proposal implies that a principles-based approach would not include definitions. We believe that definitions become more important than ever under a principles-based approach.

- The first paragraph on page 2 of the Proposal states, "Financial information cannot be useful to decision makers who cannot understand it, even though it may otherwise be relevant, reliable, and comparable." We find it difficult to understand how information could be relevant, reliable, and comparable *unless* users can understand it.

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We believe that the Board must achieve several milestones before it can begin to issue standards under a principles-based approach. The first milestone is to develop a rigorous definition of a principles-based standard. Next, as discussed in the Proposal, the Board must commit resources to enhance the conceptual framework so that it is complete, internally consistent, and clear. The next milestone would be to resolve transition issues identified above for existing standards. Finally, the Board would develop new standards under a principles-based approach including the necessary implementation protocols. We look forward to participating in the Board's future efforts to develop a principles-based approach to standard setting.

If you have questions about our comments or wish further to discuss any of the matters addressed herein, please contact John Guinan at (212) 909-5449.

Very truly yours,

KPMG LLP