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The Financial Accounting Standards Board 401 Merritt Seven Norwalk, CT 06856

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We thank you for the opportunity to comment on Financial Accounting Standards Board's (FASB's) Proposal for a *Principles Based Approach to U.S. Standard Setting* (file reference 1125-001, October 21, 2002).

Generally, we are supportive of the proposal, recognizing, however, that it is only one step towards achieving a broader objective of more transparent and higher quality financial reporting. Moreover, we recognize that development of principles-based standards will be difficult (but not impossible) in practice, and acceptance of such principles by practitioners will be dependent on factors both within and outside of the FASB's control.

One of the key issues in moving towards a principles-based approach to standard setting is differentiating between a principle and a rule. We were disappointed that the Proposal did not address this critical distinction. In the following letter, we have refrained from commenting further on this topic, except to indicate that, in our view, a principle should define the accounting for <u>all</u> transactions with similar economic characteristics. This is different than a rule, which prescribes accounting for a given transaction based on its legal form.

Nonetheless, the following discusses our views on the Proposal, as written. At the end of this letter, please find our comments to the specific questions posed on pages 10-11 of the Proposal.

#### Observations

For at least the past forty years, and perhaps even longer, U.S. GAAP generally has been promulgated through so-called "rules-based standards." These standards often prescribe a particular accounting treatment for transactions that meet specified criteria.

This approach to standard setting has inherent flaws. First, standard setters cannot possibly envision every type of transaction that should be covered by a particular rule. Accordingly, as new transactions emerge, much effort is spent by companies and their auditors in interpreting, or analogizing, promulgated accounting rules to situations never contemplated by the standard setters.

Moreover, some transactions that otherwise would be accounted for in a certain manner can be structured, intentionally or otherwise, to fall outside the scope of the rules. For example,



companies can design lease arrangements to avoid meeting any of the four criteria in Statement 13 for capitalization. Or organizations can structure an issuance of warrants to account for such derivative instruments as equity (and to not record changes in the fair value of the instruments to income), by ensuring compliance with the appropriate provisions of EITF 00-19. In most cases, the structuring is done to avoid a certain prescribed accounting treatment, yet achieving the same economic results as transactions that are specifically subject to that accounting.

The Proposal highlighted that many perceive rules-based accounting to be complex and difficult to apply in practice. The Proposal did not highlight, however, that rules-based standard setting has led to an extremely inefficient use of our standard setting organizations. Specifically, rather than dedicating resources to matters in desperate need of guidance - for instance, revenue recognition - organizations like the FASB and EITF seem to spend a great deal of time deliberating on how to "close the loopholes" in the existing rules-based standards.

For example, Statement 144 was recently issued to replace Statement 121. The fundamental guidance in Statement 121 was not changed in Statement 144. However, it appears that one of the reasons for issuing the revised standard address was issued to address perceived "loopholes" in Statement 121, including mandating the depreciating of assets held for disposal by other than sale. Also, the issuance of Statement 140 (as well as the FASB's forthcoming interpretation on special purpose entities) is another example of dedicating resources to address loopholes in existing rules-based standards. Statement 125, issued only four years prior, contained guidance on what constitutes a qualified special purpose entity, or QSPE. Transfers of assets to a QSPE achieve so-called off balance sheet accounting, a desirable outcome for some companies. Accordingly, many companies structured transactions that met the literal requirements to be considered a sale to a QSPE, but economically retained significant continuing involvement in the supposedly sold assets. Once these sorts of loopholes were uncovered, the FASB and other standard setters felt compelled to "tighten" the QSPE rules, leading in part to the issuance of SFAS 140.

Simply, the continued promulgation of rules-based standards will perpetuate this cycle of financial engineering and subsequent standards revision. This system is flawed, and needs to be fixed.

We don't pretend to think that principles-based standard is the magic bullet to cure all of the issues associated with rules-based standards. We recognize, for instance, that principles-based standards will require a substantial level of judgment, forcing companies and their auditors to critically examine certain transactions and determine the most transparent manner in which to reflect the transaction in the financial statements. Thus, the same transaction may be accounted for in different ways by various practitioners.

Nevertheless, we believe that the benefits of a principles-based standards approach, as well described in the Proposal, will vastly outweigh its costs, if the principles-based standards approach is adopted appropriately and completely.

We caution the FASB that principles-based standards can only be effective if the following guidelines are followed:



- o Keep the principle simple, and provide relevant implementation guidance.
- o Permit no exceptions, period.
- o Reduce the number of standards setters, and the types of standards they issue
- o Limit company and auditor liability when these folks honestly try to get it right.

Each of these guidelines is elaborated below.

Keep the principle simple, and provide relevant implementation guidance.

No doubt, today's transactions are highly complex. For instance, a single securitization transaction often requires upwards of ten parties to consummate, including originators, investors, servicers, ratings agencies, trustees, placement agents, conduit administrators, lawyers, tax advisors, accountants and others.

Nevertheless, the accounting for a securitization need not also be complex. In conversations with a number of bankers, most, if not all have indicated that a securitization is simply an efficient way of obtaining low cost financing. Accordingly, under a principles-based standard, proceeds from a securitization would be accounted for just like all other forms of financing – as debt.

We believe that principles-based standards will obtain greater acceptance if the principles are kept as simple as possible. Examples of such principles could include the following:

- O All derivative financial instruments are reported at fair value, with changes in fair value recorded to earnings. Furthermore, derivative financial assets that will generate future cash inflows, as of the balance sheet date, should be classified as assets. Derivative financial instruments that will cause the future outflows of cash, as of the balance sheet date, should be classified as liabilities.
- O Deferred tax assets and liabilities must be recorded for the future tax consequences of all temporary items. Temporary items represent the difference between the financial reporting and tax bases of all assets and liabilities at each balance sheet date. The tax consequences of such temporary items should be estimated based on the weighted-average effective tax rate expected to be in effect when the differences revenue. Valuation allowances should be provided for deferred tax assets when it is expected such assets will not be utilized prior to their expiry. Changes in deferred tax assets and liabilities, and related valuation allowances, should be recorded to earnings and classified as deferred tax expense.
- Pension liabilities (or assets) should be recorded based on the present value of estimated future benefits to be provided.

The general principle should be supplemented by implementation guidance, as well as examples on how to apply the principle in common situations. For instance:

 The implementation guidance for derivatives should explain the characteristics of a derivative, and include examples of the most common types of derivatives, including embedded derivatives. The implementation guidance should also explain how fair value



should be determined for a derivative, including the key estimates that must be made by management in estimating such value.

- o The implementation guidance for deferred taxes should explain the importance of preparing a tax balance sheet, and provide examples of how to calculate such a balance sheet using tax regulations that differ from U.S. GAAP. The guidance should also highlight that tax rules sometimes require certain assets and liabilities to be recorded for tax purposes, such as deferred revenues from installment sales, which are not reported under U.S GAAP. The implementation guidance should explain how to calculate the weighted-average effective tax rate, and should highlight situations in which application of the principles may not be self-evident - for instance, calculating deferred taxes resulting from outside basis differences.
- o The implementation guidance for pensions should explain how to estimate the future payments due under the pension obligation, as well as provide guidance as to the appropriate rate to use for purposes of discounting the obligation. This guidance should also include examples as to when it would, and would not, be appropriate to present the pension obligation on a net basis.

We do understand that principles-based standards may be disturbing to some practitioners. This is because applying such standards may lead to "undesirable" financial results, including the inevitable increase in the volatility of earnings. The requirement to record all derivatives at fair value, for instance, presumably would lead to the recognition of certain derivatives used economically for hedging purposes, as well as other derivatives such as employee stock options (among other items), as an asset or liability, with changes in fair value reported to earnings.

Nevertheless, we believe that the benefits of simpler guidance would greatly outweigh such "undesirable" results. We further recognize that the FASB, together with the IASB, is working toward developing a new performance statement. We imagine that the sorts of earnings volatility arising from application of principles-based standards can be captured in such a statement, particularly if separate columns are provided to track (a) the initial recognition of assets and liabilities and (b) subsequent changes in those items.

As a brief aside, here seems to be the best place for us to comment on the need for a financial reporting framework, akin to IAS 1. We strongly support the development of such a framework. Such a framework will provide practitioners with an overall set of principles that can be used to make decisions regarding the reporting of certain transactions, particularly if application of the relevant principles and related implementation guidance is unclear.

In developing an IAS 1-type framework, we recommend scrapping the existing Concept Statements, and integrating some of the key elements into the comprehensive framework. For instance, the definitions of assets and liabilities are critical elements to be included in any comprehensive reporting framework.

However, this framework should cover broader issues, such as explaining the goals and objectives of financial reporting. For instance, the framework should make clear that the goal of financial reporting is to reflect transactions based on their substance and not their form. The framework should also mandate that companies disclose all key assumptions used to measure or

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recognize material assets and liabilities, potentially eliminating the need to require certain disclosures in each and every standard. Finally, and perhaps most importantly, any IAS 1-type framework should mandate the presentation of footnotes written in Plain English.

Permit no exceptions, period.

Earlier in this letter, we discussed some of the main deficiencies associated with the rules-based approach to standards setting. However, we did not previously highlight one other flaw with this approach. Specifically, rules-based standards often contain numerous exceptions to the rules, often designed to avoid perceived undesirable accounting treatments.

As a simple example, the general provisions of Statement 109 require deferred tax assets and liabilities to be recorded for the future tax consequences "of events that have been recognized in an enterprise's financial statements or tax returns".

However, Statement 109 permits exceptions to this rule for things such as:

- o Certain outside basis differences, depending upon whether they arise at domestic or foreign subsidiaries, joint ventures or equity method investees,
- o Goodwill which is not amortized for tax purposes,
- And others.

Most every current rules-based standard contains exceptions to the rules, ranging from scope exemptions to the application of alternative rules to certain classes of transactions. The Proposal correctly points out that Statement 133 is a prime example of a rules-based standard with a plethora of exceptions, including scope exclusions for items that would ordinarily qualify as derivatives and different accounting for derivatives qualifying as hedges (and even different accounting for such derivatives based on the type of hedge).

As highlighted in the Proposal, exceptions increase the complexity in applying the accounting rules. This complexity often results in preparer, and user, confusion as to how best to faithfully represent the underlying economics of a transaction. In other more egregious instances, "financial engineers" take advantage of the numerous exceptions to design transactions that can be excluded from applying "unfavorable" accounting rules.

For these reasons, principles-based standards must avoid exceptions, in all cases. Simply, the goal of principles-based standards is to provide guidelines as to how all transactions with similar economic characteristics should be reflected in the financial statements. Providing exceptions to the standards is counterintuitive to this objective.

Moreover, allowing for exceptions, even in limited cases, provides temptation to head down a slippery slope. Admittedly, the application of certain principles-based standards may lead to financial results that may appear unusual (absent appropriate disclosure). However, making exceptions for even one of these outcomes provides precedent to make even more exceptions. Determining where to "draw the line" would be difficult, if not impossible, simply because universal support for a given standard will never occur. It is inevitable that some constituency will be unhappy with the accounting outcomes contained in a principles-based standard.



Granting exceptions in certain, but not all, of these cases will undermine the credibility of principles-based standards and perhaps of the standards-setters, themselves. Obviously, the concerns of all constituencies should be considered during the development of the principle – if the concerns are legitimate, the principle should be revised.

In summary, exceptions to principles-based standards should not be permitted or even considered by the FASB and other standards setters. Instead, such organizations should dedicate their resources to designing principles that are robust, and providing implementation guidance to address the common questions that will result from the application of the principles.

Reduce the number of standards setters, and the types of standards they issue.

With due respect to the members of AcSEC and certain other standard setting bodies, the costs of "secondary" standard setters greatly outweigh the benefits that these organizations provide. Multiple standard setting bodies cause complexity (and frustration) by providing guidance which can overlap that issued by other standard setters. In addition, multiple standard-setting increases the volume of literature that must be reviewed to ascertain the proper accounting for a transaction.

For principles-based standard setting to work, there should only be one principles-setting body. The FASB is best suited for this role.

Moreover, in the short term, the EITF should be retained. The EITF should focus on providing implementation guidance on common issues arising in practice, which were not addressed in the implementation guidance issued with the standard. The EITF well suited for this role because its members come from industry and deal with application issues on a recurring basis.

In the long-term, the volume of work at the EITF may decline significantly; if this were to happen, consideration should be given to abolishing the group. We believe a decline in the issues addressed by the EITF is possible because we are presuming that the principles-based guidance and the related implementation guidance will be written in a robust manner, obviating the need for additional guidance. We point to IFRIC, the interpretative body of the IASB, whose agenda has been lightened considerably in recent months. It appears to us that most of the topics that the IFRIC would have addressed are being considered by the IASB board itself, and embedded in the principle-based standards issued by that group.

Accordingly, the standard setting activities of other bodies, including AcSEC, the SEC's Office of the Chief Accountant and groups such as the International Practice Task Force should be discontinued immediately. However, it is appropriate for the SEC, in its regulatory role, to continue to challenge the transparency of financial statements prepared by registrants, focusing on the company's quality of disclosure.

Limit company and auditor liability when these folks honestly try to get it right.

Without doubt, applying principle-based standards, no matter how robustly designed, will force practitioners and auditors to apply greater judgment in applying the rules. Accordingly,



companies and their auditors should not fear being second guessed or be penalized by regulators and shareholders for making an honest effort to apply the standards. Obviously, these types of alternations to our legal system are well beyond the scope of change that the FASB can enact. Nevertheless, we fear the principles-based standards will not be accepted by preparers of financial statements, and their auditors, without these protections.

On the other hand, companies should be penalized for misleading investors through intentional misapplication of accounting principles, ambiguous disclosures, or omission of material facts. The SEC should remain the arbiters, at least for public companies, of whether the financial reporting is transparent, including whether the disclosures are clear and appropriate. But the SEC should refrain from criticizing the accounting selected by a company unless it clearly violates a principle.

Most importantly, preparers must fully embrace the concept of principles-based standards for the goal of more transparent reporting to become a reality. After all, they are the folks responsible with preparing the financial statements. Providing preparers, and their auditors, with relief from legal liability in instances other than for gross negligence or willful misconduct would certainly help allay concerns about providing the most transparent information to investors and creditors.

However, limiting liability is not the most effective means (nor the only way) to motivate compliance with the objectives of principles-based standards. The avoidance of a penalty for "doing the right thing" is a form of negative motivation, which leads to compliance, but at a bare minimal level. To truly motivate practitioners and auditors to comply with the spirit of principles based standards, a form of positive reinforcement should be added as well. That is, practitioners should be rewarded for issuing the most transparent information possible to shareholders.

It is naive to think that companies will pay accounting personnel bonuses for more transparent financial reporting. Therefore, to motivate preparers and their organizations to deliver more transparent reporting, they must have a reason to want to report clear and transparent financials.

As part of the Volcker reforms proposed around the time of the Enron congressional hearings, the idea of assigning grades to a company's financial statements was surfaced. We strongly support this idea, as it will give companies incentives to deliver higher quality financial information to investors, in much the same manner such companies strive to achieve better credit ratings. Simply, the higher the "transparency grade", the better the likelihood that a company will be able to obtain capital at a lower cost. In the long-term, and assuming such a grading system was universally accepted, the SEC should consider rewarding companies with higher grades by permitting them to go to market faster, similar to how seasoned financial issuers currently can employ the S-3 registration statement rules.

Obviously, standards would need to be developed for purposes of assigning grades to the quality and transparency of a company's financial reporting. The grades need not be letter grades such as A, B or C, but could be more qualitative (for example, ranging from opaque to transparent). Assessing the quality of the financial reporting might be able to be performed by either audit firms or rating agencies, such as Moody's and Standard and Poors.



#### Summary

There is an axiom that "less is more". We believe that this axiom is particularly true when it comes to the development of accounting standards.

We strongly believe that principles-based standards can lead to more meaningful and transparent financial reporting. Such standards will invariably lead to and increase in practitioner and auditor judgment, but with proper - that is, transparent - disclosure, users of financial statements will gain over the current reporting models.

Development of principles-based standards is the right first step towards more transparent financial reporting. However, to truly achieve this goal, other issues must be addressed, some of which are within, and others outside of, the control of the FASB.

Thank you once again for the opportunity to comment on the Proposal. Please find below responses to the specific questions posed in the Proposal.

#### Responses to Specific Questions Posed in the Proposal

1. 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?

As stated throughout this letter, we are supportive of principles-based standards and believe that in conjunction with the other measures outlined in this letter, will improve the quality and transparency of accounting and reporting.

2. 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?

As stated earlier in this letter, we believe that development of an overall reporting framework is critical to the success of adopting principles-based standards. We recommend that the existing Concepts Statements be scrapped in their entirety, with some critical elements integrated into a new reporting framework.

We do not believe that a "true and fair view override" should be necessary, presuming that the principles-based standards are written in a truly clear and robust manner, and that implementation guidance is developed to show the application of the principles to common situations. Specifically, we are concerned that the true and fair override may cause companies to pressure auditors to override the accounting for transactions that result in unfavorable accounting outcomes, despite meeting the spirit of the principle.

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3. 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?

We believe that interpretative and implementation guidance definitely should be presented in the principles-based standards themselves, meaning that the Board should be primarily responsible for developing such guidance

Furthermore, and at least in the short term, we also believe that the EITF should focus on providing implementation guidance on issues arising in practice, which were not addressed in the guidance issued with the standard.

4. 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?

We do believe that the constituents named above can adjust to a principles-based approach, provided that the principles are well developed, they are easy to apply, and practitioners are rewarded positively for trying to present the most transparent financial statements.

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?

We have no comment on this question.

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?

As stated earlier, the success of a principles-based approach will be dependent on two factors partially or totally outside the control of the Board. First, other standards setters must be eliminated from the standards-setting process, to avoid over-saturation and confusion in the marketplace. In addition, practitioners and auditors must not simply be punished for misapplying the standards, but should also be rewarded for presenting financial statements in a transparent manner. We strongly believe that the success of implementing a principles-based approach to standard setting is linked to these external changes.