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

Subject: Comments Regarding the Proposal *Principles-Based Approach to U.S. Standard Setting*; File Reference No. 1125-001

Dear Ms. Bielstein:

I am writing to you on behalf of the Equipment Leasing Association ("ELA") to provide comments to the Financial Accounting Standards Board ("Board") regarding the Proposal, *Principles-Based Approach to U.S. Standard Setting* ("Proposal"). The ELA welcomes the opportunity to provide information and commentary in response to the Board's request for a discussion on how a principles-based approach might improve the quality and transparency of the financial reporting and affect future standard setting in the U.S. A central part of the mission of the ELA and its Financial Accounting Committee is to provide educational information to the public as well as standards setters like the Board on matters that affect analysis of the leasing industry and its participants.

The ELA recognizes that recent events have called into question the credibility of the United States financial reporting system. We acknowledge that new initiatives may be necessary to strengthen public confidence and improve the efficient functioning of the economy. One of those initiatives may involve transitioning to a (more) principles-based accounting system. In this context, we view the Proposal as a means of framing a debate about the trade-offs inherent in adopting a (more) principles-based approach and as a basis for formulating a hypothesis about which approach would likely afford society a greater net benefit. More immediately, the Proposal and responses thereto should serve to provide useful information to the SEC in connection with Section 108(d) of the Sarbanes-Oxley Act of 2002, which requires to SEC, by July 2003, to conduct a study on "the adoption by the United States financial reporting system of a principles based accounting system."

The ELA believes that the two approaches should be viewed as (extreme) conceptual alternatives, neither of which can explain the existing U.S. reporting system and neither

of which likely can govern future standard setting in the U.S. For example, Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, reflects a principles-based policy approach. On the other hand, Statement of Financial Accounting Standards No.2, *Accounting for Research and Development Costs*, reflects a rule-based policy approach. We believe that an examination of the literature would reveal that a principles-based approach works best in certain circumstances and that a rule-based approach works best in other circumstances. We believe that an historical analysis would show that the standard-setting decision involved weighing the trade-offs and deciding the particular accounting prescription on the basis of optimality.

The ELA acknowledges that, the demand for and supply of detailed interpretative and implementation guidance, may have caused us to swing too close to the rules-based extreme and, in the process, to lose sight of the underlying goal of financial reporting. As such, a greater emphasis on principles-based approach may well be necessary in reaching equilibrium.

The ELA believes that U.S. standard setting should continue to involve a situational analysis with due consideration of the trade-offs inherent in applying either a principles-based or rule-based approach in issue resolution. We believe that each conceptual approach provides decision-useful information, particularly in terms of understanding the trade-offs. We note that FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (“CON 2”), reflects this same situational analysis approach. It defines two equal primary characteristics of decision-usefulness (relevance and reliability) and acknowledges the inherent tension and trade-offs arising from the equality of these characteristics. CON 2 implicitly rejects a binary approach, such as making representational faithfulness the prime characteristic of decision-usefulness in all circumstances regardless of the measurement error that may arise from its application.

The ELA does not believe that the Proposal has made a compelling case for swinging closer to the principles-based extreme end of the conceptual continuum. Despite recent accounting scandals or, even given the historical pattern of accounting scandals, the U.S. capital markets remains the market of choice and a broad section of participants continue to place relatively greater confidence in the U.S. financial reporting system. We also note that the recent accounting scandals that prompted this review and discussion of principles-based approach resulted from a “breaking of rules.” Accordingly, we believe that a more persuasive case can be made for vigorous oversight and enforcement than for making a pronounced change in the U.S. standard setting approach.

The ELA supports a centrist solution, an approach that is neither too principles-based nor too rule-based approach. Over the course of time, in the accounting for leases, we have experienced the two extreme ends of the standard setting continuum and, at either extreme, encountered considerable controversy about the resulting prescription. For example, APB Opinion No. 5, *Reporting of Leases in Financial Statements of Lessees*, reflected a principles-based approach to lessee accounting. This approach failed to achieve the intended symmetry in the accounting and reporting of similar transactions. Its replacement standard, Statement of Financial Accounting Standards No. 13,

Accounting for Leases, attempted to resolve this issue by adopting a rule-based approach. Swinging from one extreme to the other has not resolved user concerns about lease accounting.

The ELA has encountered similar controversy about the appropriate approach to take in the accounting for sale-leasebacks and certain defeasance arrangements (e.g., those involving three parties or economic defeasance). For example, the U.S. standards reflect a detailed rule-based approach (including exceptions) intended to prevent abuses while the corresponding International Accounting standards use a more principles-based approach intended to portray the underlying economics. Hence, the adoption of a principles-based approach will likely require U.S. standard setters to allow economic considerations to prevail over normative considerations, particularly if greater convergence is desired.

This letter includes two attachments that provide a detailed analysis and discussion of issues relating to adoption of the principles-based approach articulated by the Proposal. Attachment 1 (entitled "Comments on the Issues") contains our responses to the six explicit issues raised in the Proposal. It also contains certain additional issues that we believe that the Board should consider in progressing this important project. Attachment 2 (entitled "Case Study: A Review of the Principles-Based Approach Used by the U.S. Legal and Income Tax Systems in Regulating True Leasing") intends to provide the Board with an analogous application of a principles-based approach in the U.S. This case study discusses important environmental factors and maintenance issues.

We appreciate the opportunity to comment about this important Board project. We remain available as a resource to the Board and its staff to provide additional or clarifying information. Please feel free to contact me at any time to arrange for follow-on information.

Sincerely,

Michael Fleming

Michael Fleming
ELA
President, Equipment Leasing Association

ATTACHMENT 1

Comments on the Issues

- 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 the U.S. financial and reporting?**

Proposal for Principles-Based Approach

The ELA supports a principles-based approach as an underpinning of and potential override to the “rules of the road.” We do not support exclusive reliance on a principles-based approach to U.S. standard setting. We support a centrist approach to standard setting, that is, an approach that seeks to optimally combine the two rival approaches in a manner consistent with U.S. legal and cultural realities.

The ELA concurs that an overly rule-based approach can cause participants to lose sight of the goal of financial reporting, a distraction that can lead to an inefficient allocation of resources. On the other hand, we believe that an overly principles-based approach can reduce comparability and may create information asymmetry. While the Proposal acknowledges the comparability issue, it does not discuss the “level playing field” issue. The Board should also recognize that an overly principles-based approach might create a situation where certain participants gain or provide privileged access to interpretative views (either by frequency of interaction or firm restrictions on private contracting) and use such access as a means of competitive differentiation. From another perspective, as noted in the Proposal, over reliance on a principles-based approach can result in de facto private standard setting without the benefit of due process. Accordingly, while we believe that a principles-based approach can play an important role in application of rules in the U.S., we would not support its adoption without adequate communication mechanisms to prevent undue subjectivity and privatization of accounting information.

The ELA believes that the IAS version of a principles-based approach cannot be readily adapted in the U.S. due to significant legal and cultural differences. From a legal perspective, the U.S. imposes significantly greater liability on its professions in general and public accountants in particular. From a cultural perspective, we believe that the U.S. generally approaches regulation of free enterprise under the premise that self-interest drives all participants (including regulators). U.S. history shows that U.S. society favors regulatory restraint based on a system of checks-and-balances, full and open disclosure (“sunshine” provisions), and vigorous enforcement of lawbreakers. We do not believe that U.S. society would support switching to an approach based on governance by the few despite the nobleness of the purpose. Accordingly, the ELA does not support a principles-based approach that would entrust governmental agencies or private audit firms who are involved in public service with broad discretionary power.

The ELA believes that the debate about which standard-setting approach to use in the U.S. is similar to the broader societal debates about the merits of objective (rule-based) versus subjective (principles-based) approaches in education, employment, and taxation. In these areas, while U.S. society recognizes the issues arising from over reliance on objective standards and rules, it nonetheless supports the primacy of a rule-based approach in that such an approach provides clear measureables, leading to comparable treatment and efficiency. From this perspective, the Proposal appears to offer an “out of context” solution.

Improving Quality and Transparency

The ELA supports continuous improvement in financial reporting and supports the full and fair vetting of any initiatives offered up to do so. We believe that a principles-based approach can play a strategic role in improving the quality and transparency of financial reporting. However, we envision a more limited and targeted role than the broader role advanced by the Proposal.

We believe that the Board should advance a principles-based approach as a means to improve a market-based discipline. For example, by framing the rules in a principles-based context, the Board could establish the basis for issuing post-pronouncement public notices about emerging accounting practices that it considered to be contrary to the intent and spirit of the rules. Further, with a clearer articulation of the principles that underlie the rules, the Board could more readily fast track changes in the rules. We believe that this targeted approach could better serve the market. It likely would prevent significant transition problems for market participants. It would also serve to prevent over-regulation or “collateral damage,” an observable phenomenon when a rule-over-principle based practice has been allowed to become prevalent enough to precipitate a financial reporting crisis.

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?

The ELA supports a principles-based approach that can serve as an override to an accounting rule in the situation where application of the rule does not result in a fair depiction of the economic substance. However, we do not believe that the U.S. needs to turn abroad and import the IAS overall reporting framework to address current concerns about U.S. financial reporting. We favor restating and reinvigorating the current reporting framework. As noted in the Proposal, the U.S. reporting framework includes pronouncements that emphasize applying GAAP in such a way as to portray the underlying economics (i.e., Rule 203 of the AICPA Code of Professional Conduct and Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*.)

The Proposal does not explain why the existing overrides currently found in U.S. reporting framework may not work as effectively as the overrides contained in IAS 1. We believe that the Board needs to conduct more research and consider alternative solutions before framing this issue.

The ELA also believes that a “true and fair view override” raises the cost of doing business under a principles-based approach. It means granting broader discretionary power than that implicit in adopting a principles-based approach. If the Board decides to pursue the development of an IAS 1-type framework, it should ensure that the circumstances under which it can be invoked are limited and that adequate checks and balances exist to prevent abuses.

The ELA believes that the use of a principles-based approach as a “true and fair” override implies even-handedness and an emphasis on portraying the underlying economics. It should not then be used as a means to introduce undue conservatism. It also implies that inconsistencies or departures from existing GAAP might be acceptable. For example, assuming adequate supporting evidence, why shouldn’t bargained for upside potential (fixed priced purchase option) received in exchange for acceptance of downside risk (residual guarantee) not be reported? Further, a “true and fair” override also implies acceptance of accounting that mirrors observable market practices. For example, if the market prices tax leases based on the pattern of after-tax cash flows, why shouldn’t the net cash investment method apply to non-leveraged tax leases? Accordingly, we believe that the Board needs to address the above-described implications as part of its discussion and analysis of this issue.

- 3. Under what circumstances should interpretative 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?**

Interpretative and Implementation Guidance

The ELA believes that robust interpretative and implementation guidance should be provided regardless of the approach taken to standard setting. We note that, if the accounting profession were federalized, such guidance would be provided as matter of law and practice. We do not believe that a reduction or elimination in guidance is warranted if the U.S. society continues to entrust the private sector with regulatory responsibilities. As discussed elsewhere in our response, the ELA believes that the failure to provide robust guidance would be contrary to U.S. legal and cultural realities, might create information asymmetry, and could limit productivity gains. Further, absent mechanisms to communicate broadly interpretative and implementation guidance, the ELA believes that the audit profession cannot appropriately conclude that the financial statements have been prepared in accordance with “generally accepted accounting principles.”

Primary Standard Setter

The ELA believes that the Board should serve as the primary standard setter responsible for providing interpretive and implementation guidance for both consistency and efficiency purposes. Most business and governmental entities have found that increased centralization leads to productivity gains, measured in terms of both efficiency and effectiveness.

We believe that the FASB should follow the business model in implementing a centralization initiative. First, it should size the economies of scale benefit arising from taking over all private sector standard setting and potentially reducing the levels of GAAP (a process described as broad-banding in business). Second, it should establish clear measureables against which to evaluate its performance. Third, it should establish mechanisms to assess its on-going performance.

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?

The ELA believes that the Proposal's envisioned change in behavior cannot be achieved without fundamental changes in the U.S. legal, regulatory, and educational systems. The following table provides a high level summary of the changes that we believe would need to be done and by whom:

What Needs to be Done	By Whom
<p>Legal</p> <ul style="list-style-type: none"> • Limited liability. New legislation to limit liability for preparers and auditors upon a showing that the parties made a good faith judgment consistent with information available in the public domain and any internal guidance. • Funding. Increased budgeting for oversight and enforcement with minimum funding requirements tied to market size. 	<p>U.S. Congress</p> <p>U.S. Congress/SEC</p>
<p>Regulatory</p> <ul style="list-style-type: none"> • New Regulations. Issuance of new regulations that sets forth the policy and procedures that allows professional judgments to stand absent manifest error. 	<p>SEC</p>
<p>Educational</p> <ul style="list-style-type: none"> • Publications. Issuance of articles and notices to clarify the intent and spirit of the standards in the context of market developments. • Education. Revised accounting curriculum and continuing education requirements, involving increased exposure to finance and legal disciplines. 	<p>FASB</p> <p>AICPA</p>

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 ELA believes that the cost-benefit equation depends on the consensus reached on “what needs to be done” and “by whom” (see Issue 4).

Potential Benefits and Costs

The ELA believes that the adoption of a more principles-based approach to U.S. standard setting does not in itself ensure certain benefits will be realized or costs incurred. It may increase the odds of success, but the ultimate outcome likely will depend on the specific actions taken by the regulators in the name of principles and the leadership that it inspires in the private sector.

Potential Benefits. We have reviewed the benefits discussed in the Proposal, such as broader standards should be easier to understand and implement and that few, if any, exceptions to the principles should increase comparability. At this stage of the project, we view the listed benefits to be hypotheses. The Proposal does not offer clear, convincing evidence in support of these hypotheses (envisioned benefits). Based on historical experiences in other similar regulatory environments, we believe that a stronger case can be made for an opposing view. For example, as discussed at Attachment 2, the principles-based approach used in the governance of leases for tax and legal purposes (which is based on substance over form approach) has generated an increased need for interpretative and implementation guidance. Additionally, we believe that past academic research studies have shown that a substance over form approach means adopting finite uniformity where facts and circumstances necessarily lead to exceptions to the general rule. This same body of literature has shown that rigid uniformity (the no exceptions alternative) creates “winners and losers” and concentrations of wealth contrary to U.S. social goals.

Potential Costs. We concur that the Proposal details some of the significant potential costs relating to adoption of a more principles-based approach. As discussed elsewhere, we believe that these costs could also involve far-reaching costs to society, such as information asymmetry and burden of incremental compliance costs that do not yield commensurate benefits.

Quantification of Benefits and Costs

We believe that the costs involve transfer payments from one sector of the economy to another that can only be rationalized by the resulting increase in the economic pie.

Sizing the Benefit. One way to size the maximum benefit is to assume that it equals the economic losses arising from the recent wave of accounting scandals. For analytical purposes, it could also be assumed that the future economic losses from undetected fraud

would approximately equal the future economic gain from the reduction of counterproductive financial engineering.

Sizing the Costs. We believe that the costs can be estimated by placing a price tag on each proposed initiative, summing of costs of the different sets of initiatives that collectively would serve to minimize fraudulent accounting, and then selecting the lowest cost set. For example, the ELA’s proposed limitation on professional liability discussed at issue 4 can be sized as the difference in the resulting legal settlements (actual awards vs. likely awards under the proposed limited liability alternative). The SEC could size the cost of ELA’s full funding proposal for oversight and enforcement actions. And so on.

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?

The ELA believes that the Board needs to consider two other important factors in assessing the extent to which the Board should adopt a principles-based approach to U.S. standard setting. First, the Board should consider cultural differences between the U.S. and those countries under the IAS. Second, the Board should consider the educational challenge relating to the proposed change in approach.

Cultural Differences

The IAS standards generally apply to more highly regulated economies and societies that do business under a distinctly different legal system. The Proposal does not cover these realities as an important backdrop.

The Proposal also appears to offer a solution contrary to fundamental U.S. socio-economics. We believe that research studies show that the U.S. is built upon the premise that parties act in their own self-interest and that a fair, open market represents a more powerful mechanism of regulation that one based on the discretionary intervention by a professional class. For example, by applying the “self interest” premise in the context of reduced public information about implementation and interpretative guidance, the Proposal should conclude that auditors would likely adopt overly conservative positions and conduct exhaustive analyses with counterproductive benefits absent countervailing factors. The Proposal should acknowledge these realities and the need to create an offsetting dynamic. We believe that, consistent with U.S. history, enhanced communications mechanisms provide the appropriate offset.

Educational Challenge

The Proposal does not explain how to retool the audit profession in support of a more principles-based approach. How will educators prepare students, especially if the change would involve a reduction in publicly available information on implementation and interpretative guidance? In seeking to prepare for “substance over form” regime, would it be better for students to major in finance or economics with a concentration in business

law? Or should accountants be required to undergo specialized training, similar to the specialized training needed to practice law or medicine (or, alternatively, a post-degree certificate approach similar to that used in certifying financial analysts)? How should the CPA exam be revised to ensure qualified licensees? How should today's rule-based auditors be brought up to speed on the economic fundamentals of business? We believe that the Board will need to address these types of issues.

Additional Issues

7. Does the Proposal appropriately frame the reporting system issue?

No. The ELA believes that the Proposal inappropriately frames the reporting system issue as “whether the U.S. should adopt a principles-based approach?” This framing implies that the current U.S. reporting system uses a rule-based approach that has been shown to involve major deficiencies. When framed in such extreme terms, who could object to the proposed change in orientation? Alternatively, if the reporting system issue were framed as “should the U.S. abandon its current objective criteria-based approach,” then a similar distortion of the principles-based approach would result.

We believe that the issue should be framed as “How can a principles-based approach be best applied in the U.S.?” The ELA believes that society cannot efficiently or effectively function without rules/objective standards or without principles/subjective standards. Productivity inherently depends on a rule-based regime. For example, software solutions cannot be implemented without rules and protocols. Alternatively, the basic speed law cannot serve to replace the rules of the road. Or, the income tax system cannot fairly redistribute wealth without rules and exceptions. However, tax fairness requires a principles-based approach (e.g., business purpose) to ensure that rigid application of the rules does not cause unintended consequences.

8. Does the Proposal appropriately source the reasons for the current reliance on a more rule-based approach in the U.S.?

The ELA believes that the Proposal does not comprehensively or fairly address the source of user concerns. The standard-setters have significantly contributed to an overly rule-based approach. For example, compare sale-leaseback accounting under the IAS and the FASB standards. The complexity of the U.S. standards arises from “normative” considerations instead of economic substance considerations. The same normative driver can be observed in comparing IAS and FASB standards in defeasance accounting and joint ventures.

The ELA believes that a fair solution cannot be made unless a fair diagnosis of the problem is made. Accordingly, it recommends that the FASB review recently issued pronouncements to determine the drivers. For example, why did the EITF need to step in and provide guidance on shipping and handling costs or vendor rebates when there were no detailed rules to circumvent? Why couldn't the auditors apply a principles-based

approach and obviate the need for EITF pronouncements on these matters? Would the auditors have behaved any differently if the proposed principles based approach were in effect?

9. Does the Proposal define the appropriate starting point before determining the potential incremental benefits arising from the proposed change in approach?

The ELA recommends that the FASB define the starting point before determining the potential incremental benefits of introducing a more robust principles-based approach. We believe that the starting point should be defined as the environment likely to exist upon the completion of certain active and contemplated projects. In so doing, it can better determine the incremental benefit of undertaking a principles-based approach. For example, we believe completion of the FASB's current projects on codification and revenue recognition should resolve significant practice problems. We also endorse the contemplated conceptual improvements project to address significant standard-setting problems and to reinforce the "tone of the times." We believe that completion of the projects will significantly reduce concerns about undue complexity and form over substance.

ATTACHMENT 2

**Case Study: A Review of the Principles-Based Approach
Used by the U.S. Legal and Income Tax Systems in Regulating True Leasing**

The ELA believes that it can provide unique insights into the debate about proposed adoption of a more principles-based approach. We have had simultaneous experience with the rival approaches, a more principles-based approach under U.S. legal and tax law and a more rule-based approach under U.S. GAAP. The U.S. legal system uses a more principles-based approach in deciding rights and obligations of the contracting parties. If the substance of the risk/reward arrangement parallels that of a loan, then it falls under Article 9 as a secured lending transaction. If the substance of the transaction involves the lessor's retention of a meaningful interest in the residual value of the leased property, then it falls under Article 2A as a true lease (an executory contract subject to rejection where the lessor has a reversionary interest in the property). The U.S. tax system follows a very similar approach the U.S. legal system. Additionally, the U.S. system considers the business purpose of a transaction. By contrast, the U.S. GAAP treatment of leases has largely involved a rule-based approach.

The ELA believes that the FASB should consider reviewing the principles-based approach applicable to true leasing as a helpful case study. The Internal Revenue Code provides principles, not bright-lines, in determining tax ownership. However, in order to make the principles operational and to facilitate efficiency, the Treasury found it necessary to provide an advance ruling mechanism in providing individual taxpayers with guidance on their pending deals. The Treasury drew on its ruling experience and published guidelines to expedite processing. Over the course of time, the publication of these guidelines, among other regulatory developments, allowed taxpayers to determine independently the likelihood that a particular lease would qualify as a true lease. However, regulators or market participants have found since found it necessary to provide or receive on-going guidance to achieve comparability. This guidance has taken the form of court cases, private letter rulings, field service advice memorandum, and release of documents under the Freedom of Information Act. The tax attorneys have needed this living body of guidance to interpret appropriately the Code's principles-based approach in the context of dynamic market conditions.