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Members of the Financial Accounting Standards Board:

# Re. File Ref. 1125-001 - Proposal for Principles-Based Approach to U.S. Standard Setting

Thank you for the opportunity to respond to this very timely issue. It has many ramifications and the road is not easy. To put my comments into perspective a brief C.V. follows. I served as senior technical partner and Chairman of the Policy Committee of Arthur Young & Company (now Ernst & Young); as Senior EVP and CFO at Warner Communications (now AOL Time Warner) and at a multi-billion dollar private holding company (MacAndrews and Forbes) involved in the takeover activities of the 1980s; and, at present, owner of FLT Investors a boutique investment firm. So, I have had the privilege of seeing the evolution of GAAP from "both sides of the desk."

### **Summary**

- 1. A principles-based approach is the correct way to establish accounting principles. The word "principle" in itself connotes fundamental guidelines. Having said that, however, a principles-based approach should not be devoid of guidance. The issue is not guidance vs. non-guidance but the amount of detail and that should depend on the complexity of the subject matter. Establishing a principles-based approach involves both the technical issues mentioned by the Board as well as a number of environmental factors, many of which also have been highlighted by the Board. Prior to the FASB, the Accounting Principles Board's Bulletins were somewhat akin to principles-based pronouncements. It is important to understand why they were not successful.
- 2. In the environment/culture of the past several years, principles-based standards likely would have led to a greater number of misleading financial statements than those issued by the FASB. Principles-based standards must be developed within a receptive environment. Therefore, many of the corrective actions in process today must change certain aspects of our culture for this approach to accounting principles to succeed.
- 3. In order to achieve acceptance, principles-based standards must be grounded on a clear and comprehensive foundation of the basic concepts of financial statements.
- Principles-based standards also must be grounded on the concept, a predicate if you
  will that <u>SUBSTANCE MUST PREVAIL OVER FORM WHEN THEY</u>
  MATERIALLY DIVERGE.
- The rationale as to why a principles-based approach will result in financial statements that are clearer and more comparable needs to be expanded and strengthened.
- 6. The method of transition to a principles-based approach needs to be decided.

#### My comments are in four sections:

- 1. Viewing the Past to See the Future.
- 2. Environmental and Other Considerations.
- 3. A Principles-Based Approach is Correct.
- 4. Responses to Questions Raised in the Proposal Memorandum.

### Viewing the Past to See the Future

It is said by at least by some philosophers that "all goes 'round 'til it comes 'round." In the early days, GAAP was expressed in Accounting Principles Board Bulletin 43 (APB 43) et seq. These expressions of GAAP were in many respects more akin to a principles-based approach than is the case today. Unfortunately this approach at that time lost favor.

It is important to understand the business environment as it affected accounting principles and the practice of auditing at the time this approach was losing favor. The early 1960s was a "go-go" period during which a number of mergers occurred to form conglomerates which were to provide companies and investors protection against the vicissitudes of business cycles. A number of new types of securities were created to accomplish these mergers primarily aimed at avoiding the dilution of earnings per share that would have resulted had the acquirer issued common shares. Financial engineering in its carly stages! It was the view of many that the profession was behind the times in promulgating principles to cope with this merger activity. Further damage was done to the profession and GAAP during the 1970s when, as a result of a wave of bankruptcies, we heard "Where were the auditors?". And again we heard from some their belief that accounting principles were not responsive because they were not evolving quickly enough. A familiar cry!

A consensus emerged that a part time board was not adequate for standards setting and that broader representation was needed. Establishing the FASB has satisfied these issues. Another issue related to a perceived lack of consistency in the application of accounting principles and thus a lack of comparability between financial statements. [We now see that promulgating more detailed accounting principles did not by itself solve this problem.] Additionally, a conceptual framework was (and is) needed on which accounting principles would be grounded. [The Board in its Proposal recognizes that the existing conceptual framework contains inconsistencies and inadequacies.] Without such a framework inconsistencies arise as between principles as well as the application of a principle. Further, it is my strongly held belief, based on many years spent in the

profession and "on the other side of the desk," that a very important failure of the time (and today) is the lack of a comprehensive pronouncement dealing with the fundamental issue of substance over form. Pursuant to this principle, the substance of every business transaction (event) will determine the appropriate accounting principles irrespective of the form in which the transaction is cast.

From this view of the past we can easily discern what the future requires. More about this below.

### **Environmental and Other Considerations**

#### **Environmental Considerations**

Key to going forward with principles-based standards is the need for a number of changes to the present environment. We have a public believing that the problems we have faced during the recent past are systemic. They have lost confidence in government, managements, auditors, Wall Street and the results presented by financial statements. This environment is less receptive, more hostile, to a principles-based approach than was the case during the days of the Accounting Principles Board.

The present problems, as indicated below, result from a failure by members of the accounting profession and the business community to act in the public interest. The success of principles-based standards will rest in good part on the success we have in implementing the required changes to restore public confidence.

Prior to the late 70s or early 80s, the exact date is not important, the accounting professions Code of Professional Conduct prohibited members from competing for business. The elimination at that time of non-compete provisions, as required by the Department of Justice, resulted in firms competing overtly and aggressively for new clients. This change also resulted in firms advertising for business. Further, as a result of the activities of the Senate Oversight Committee headed then by Senator Metcalf, the profession adopted a number of internal procedures to improve performance. Two results

of the foregoing are a significant increase in the cost of doing business and a reduction in revenue dollars per hour, as auditors frequently were in bidding competition for business. These events put pressure on firms to seek new sources of revenue (in addition to auditing) and to retain existing clients. I believe an unfortunate result in some cases was a lessening of the effectiveness by which the firms monitored the application of GAAP.

On the corporate side, we have a dramatically heightened emphasis on short-term results supported by compensation structures that are keyed to these short-term accomplishments. This has created enormous pressure on executives to maintain earnings momentum and therefore stock prices. We have seen the consequences.

Our ability to establish principles-based standards is dependent on our ability to create an environment in which they will be applied with integrity and in the public interest by preparers and auditors. Sir David Tweedie has expressed this need with great clarity. He said "Our approach [a principles-based approach] requires both companies and their auditors to exercise professional judgment in the public interest. Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures. It will not work without these commitments." I cannot think of a better way to describe the environment in which a principles-based approach can work.

Recent legislation—the Sarbenes-Oxley Act of 2002—provides an initial thrust to solve the environmental issues. Now the SEC must promulgate specific rules as required by the Act. Additionally, shareholder groups are putting pressure on managements and auditors to adopt a number of changes. Time will tell how effective this will be. We know that it is not possible to legislate morality. Rather, these reforms must be accepted because they will benefit all.

The point is the process of establishing principles-based standards is dependent in good part on bringing about the changes necessary to restore confidence in our capital markets.

#### Other Related Considerations

The overhang of litigation and administrative and criminal actions by various governmental agencies further complicates the issue. Will preparers and auditors be willing to exercise greater professional judgment as would be required under a principles-based approach? Working closely with the SEC and the new Public Company Accounting Oversight Board should reduce the risk of inappropriate litigation and/or SEC actions.

Then there is the issue of "resource rich" firms and "non-resource rich" firms. The former will have the financial and other resources to provide operating guidelines for applying accounting principles while the others may not. Therefore, it will be necessary for the profession to provide greater opportunities for education to this latter group.

## A Principles-Based Approach Is Correct

Under the present approach to establishing accounting principles we are suffering from a "principles overload." Since this view has been expressed by many it isn't necessary to dwell on the details. Many practitioners are simply not capable of coping with the volume of rules. One result of this overload is that one can easily lose the "forest for the trees." It is possible to lose track of the substance of a transaction while looking through a volume of rules to find those that appear to apply. Further, it is at times easier to discern the form of a transaction rather than its substance and therefore hunt for a rule that has the same or similar characteristics as the form. We may get lazy and use the rules as a crutch in lieu of applying professional judgment. I believe these problems would be substantially reduced by a principles-based approach.

Clearly a principles-based approach would reduce the volume of data. A standard would provide guidance but it would be much less detailed than at present. A principles-based approach would require the greater use of professional judgment. This is good. It can, however, in the real world create new problems. There is always the possibility of increased litigation and or SEC actions when one cannot point to specific rules in direct

support of one's actions. As mentioned above, developing principles-based standards in concert with the SEC and PCAOB should reduce the risk of inappropriate litigation and SEC actions.

I believe it is likely that a principles-based approach will result in accounting principles being issued on a more timely basis. Not that less thought will be required; rather less time will be devoted to guidance, i.e. what should be included and lengthy debates over language. The ability to be timely as we see from history is very important. Relative to being timely is arriving at a balance between deliberation and urgency.

#### The Need for a Foundation

For a principles-based approach to succeed it is imperative to have a complete conceptual framework on which accounting principles will be grounded. As part of that framework or separately, it is equally imperative that we have a clear pronouncement of the principle of substance over form. This pronouncement must set forth the fundamental characteristics that determine the economic substance (business purpose) of a transaction. It must provide that substance will prevail when the form of a transaction diverges materially. Additionally, I support the idea of creating a statement such as IAS 1 (Revised) *Presentation of Financial Statements*. It would set forth guidance as to matters critical to the preparation of financial statements.

#### Benefits to be Derived

If the Board believes strongly that clarity and consistency are major benefits of principles-based standards, it needs to set forth a more substantial and convincing rationale than that expressed on pages 9 and 10 of the Proposal.

For example, the idea that eliminating exceptions to principles should increase comparability seems hollow. Presumably the exceptions apply to similar transactions or circumstances and therefore exceptions will be handled comparably, as will non-exceptions. It is likely that with broad standards and less detail and complexity, along with the application of professional judgment, financial statements will be more concise,

clearer and more comparable. Conciseness and clarity could result from eliminating much information presently called for by detailed guidance that in the judgment of the professionals involved in a particular situation is not necessary. Or, information may be presented in a more meaningful "unconventional" manner because it is clearer in the circumstance and broader standards would permit this flexibility. Greater consistency also could result from reducing the volume and complexity of GAAP and therefore simplifying its application. See additional discussion in first three paragraphs under "A Principles-Based Approach is Correct."

#### The Transition

How do we move from the present method of standard setting to the principles-based approach? Do present standards exist "as is" while new standards follow the principles-based approach? Do we reformat existing standards into the new approach? If so, over what period of time? What is the status of "excess guidance" in existing standards during the transition to the new approach? One approach is to recast existing standards starting with those with the broadest application and release them over time so as not to create an overload.

### Responses to Questions Raised in the Proposal Memorandum

- See "A Principles-Based Approach is Correct". As to improving quality and transparency, I believe a principles-based approach will result in improvements. See "A Principles-Based Approach is Correct-Benefits to be Derived."
- 2. As mentioned under "A Principles Based Approach is Correct-The Need for a Foundation" there is a need for an integrated foundation upon which the principles would be grounded. It would set forth a conceptual framework, including a statement as to the primacy of substance over form as well as the matters set forth in IAS 1. As to a "true and fair view" override, I do not share the concern that it would undermine the principles in the standards. A similar override exists in the professional Code of Ethics and it should be continued in lieu of a new "true and fair" standard. To my knowledge it is seldom used. The burden of

- proof for its application is a very heavy one. One would have to demonstrate circumstances so unusual that the application of GAAP would have resulted in misleading financial statements. This burden serves to prevent an override.
- 3. A standard should set forth only such guidance as is necessary to ensure that its concept is clearly conveyed. The amount of interpretive and implementation guidance should depend on the complexity of the standard's subject matter. For example, a standard on derivatives would require more guidance than would a standard dealing with interest capitalization. In fact, I believe that Attachment B is too detailed. Examples of excess detail are paragraph 8,10,46 which appears only to reiterate that the Standard should not be applied to immaterial items and on the same page citing that to which the standard does not apply isn't necessary; paragraphs 12,51-13,14,52-16,56-15 and the examples in paragraph 18,61 aren't necessary. Paragraph 12,51 states a point that is fundamental to and implicit in the concept of capitalizing interest. The remaining paragraphs deal with mechanics of the capitalization process and are not difficult or unusual notions and therefore should be left to one's professional judgment. As to who should be primarily responsible for guidance, the task should sit with the Board and it should work closely with the SEC and PCOAB. The recent move by the Board to limit the sources of guidance is correct.
- 4. I do not see how the named parties can fail to adjust if the benefits cited by the Board are a result.
- 5. I do not believe cost will be a significant factor or that it can reasonably be quantified. The Board has identified the benefits although as pointed out above under "A Principles-Based Approach is Correct-Benefits to be Derived" the Board needs to express its views in a more convincing way. Additional considerations include those matters discussed under "Environmental and Other Considerations" particularly the need for the environmental changes discussed therein. This is vital for a principles-based approach to be successful. Also, the manner in which to carryout the transition to a principles-based approach needs to be decided. See "The Transition" above.

Please feel free to contact me with questions you may have.

Yours truly,

Fred L. Tepperman FLT /sd