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# By email

Director of Major Projects and Technical Activities Financial Accounting Standards Board

#### File Reference No. 1125-001

The American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to comment on the FASB's October 21, 2002, proposal for a principles-based approach to accounting standards setting in the United States. Our member constituents to financial reporting include auditors, educators, and preparers of financial statements. We share one overriding goal as it relates to the proposal—the continuing improvement of financial reporting in the United States.

First, we would like to express our belief that United States accounting standards currently are based on robust principles, and that "principles-based" may thus be a misleading description of how future accounting standards should differ from current accounting standards. We nevertheless use the term *principles-based* hereinafter for convenience.

The AICPA supports a movement towards principles-based standards. We believe that such a movement is needed to ensure that financial statements are faithful representations of economic activity and thus that financial statements continue to be relevant tools for making investment, credit, and other decisions. We believe, however, that the Board needs to do more work defining the essential elements of the new model standard. Without identification of those essential elements, the Board's constituents may not fully understand how the Board intends to achieve the goals and objectives outlined in the proposal and, ultimately, consistency in standard setting will be difficult to achieve.

We also believe that the Board needs to improve the conceptual framework ahead of the development of principles-based standards. As the Board noted in the proposal, certain aspects of the conceptual framework are incomplete, internally inconsistent, and ambiguous. For the Board to be able to develop clear and well-articulated principles, it must have a sound foundation for resolving accounting and reporting issues. Furthermore, the conceptual framework likely will take on greater practical importance to preparers of financial statements and auditors in applying principles-based standards.

We recognize that the setting of standards in this undertaking will require the Board to balance competing needs. Among the needs that the Board should consider are the following:

The need for comparability of financial statements

- The need to understand the litigious and regulatory environment in the United States
- The need for industry-specific guidance
- The need for implementation guidance
- The need for an appropriate transition

#### Comparability

Principles-based accounting standards would require a greater reliance on professional judgment than do current accounting standards, which would result in some divergence in practice because different people would reach different conclusions in good faith. Practice differences stemming from contrary interpretations of the same standard would be partially (or, perhaps, more than) offset by elimination of the divergence that results from the structuring of transactions around detailed "rules" and from the numerous exceptions in current standards.

There may be a significant net increase in divergence, however, if the Board conceptualizes *principles-based* at too high a level. That is a major concern because comparability affects greatly the usefulness of financial statements. We therefore urge the Board to conceptualize *principles-based* in such a way that standards are sufficiently robust that users of those standards understand the results intended by the standards. We believe that recent FASB exposure drafts on guarantees and special-purpose entities lacked clarity, and we hope that those proposed pronouncements will not serve as models for the principles-based approach.

## Litigious and Regulatory Environment

Shielding preparers and auditors from legal liability for the way they carry out their professional responsibilities should not be the Board's goal. However, the quality of financial reporting would be served poorly by standards that unnecessarily expose preparers and auditors to legal liability for informed accounting decisions made in good faith. Thus, accounting standards should be understandable, and the authoritative literature should be internally consistent.

In our experience through our enforcement activities, practitioners who have been accused of violating accounting standards have argued that, because they have complied with the letter of the standards, they cannot be found to have violated those standards even if they have not complied with the spirit of the standards. We believe that principles-based standards can be an effective way to eliminate that practice. However, we also have had experience enforcing standards that are less prescriptive and more principles-based. In the latter situations, practitioners tend to argue that the rules are not prescriptive and, therefore, that their judgment should prevail. These matters are obviously difficult to enforce and can result in regulators (and the courts) setting de facto standards on an ad hoc basis.

If principles are intended to allow different preparers, based on sound professional judgment, to treat similar transactions differently, FASB should state that clearly. Additionally, the Board should be certain that it has the explicit support of those involved with overseeing and regulating financial reporting. If the Board decides to move forward with principles-based standards, regulators such as the Securities and Exchange Commission, the Public Company Accounting Oversight Board, the Office of the Comptroller of the Currency, the Inspector General community, and others must support the effort and be willing to accept accounting positions taken in good faith, even if those positions might be contrary to the views of regulators. To usurp a principles-based standard with detailed regulatory accounting rules or after-the-fact second-guessing by individuals or enforcement personnel not on the front line of decision-making will not serve the public well, nor will it accomplish the Board's objectives. Principles-based standards, in fact, require supporting a professional-judgment approach.

### Need for Industry-Specific Guidance

We believe there will continue to be a need for industry-specific accounting guidance under principles-based standards. For example, we believe that guidance would still be needed on what qualifies as the acquisition of an insurance enterprise, either through a purchase of a business or reinsurance of a block of business. If industry-specific guidance is not provided by the FASB, the AICPA expects to provide that guidance. Otherwise, other organizations that do not have the appropriate motivation and expertise would fill the void.

We believe the AICPA is the best body to provide such guidance. The AICPA has been a significant resource for the Board in the past, and we intend to play a major part in providing guidance to our members in the future.

## **Need for Implementation Guidance**

Different preparers and auditors may need different levels of implementation guidance. For example, the effort required to think through an implementation issue may not be an unreasonable burden on large auditing firms because they have the necessary manpower and resources to do so. That same effort will be onerous for a smaller firm and will lead to inconsistencies in practice and wasted efforts attempting to "reinvent the wheel."

While we recognize that principles-based standards would require preparers and auditors to apply professional judgment in more circumstances, we note that the quality of financial reporting will not be improved by unnecessarily requiring certain efforts to be duplicated by a host of firms. Adequate implementation guidance should be provided to satisfy the reasonable needs of all of the Board's constituents. The AICPA is committed to assisting CPAs that seek help applying FASB standards, thereby leading to better financial reporting and the best capital markets system in the world. In this litigious society, it is unreasonable to assume that profession-wide or commercially provided implementation guidance will not occur, which reinforces the point we made in the comparability section of this letter.

#### Transition

It is unclear how the transition to principles-based standards would be managed. For example, would all existing "rule level" guidance be eliminated before new principles-based standards are implemented? If not, would the existing standards be compatible with the new principles-based standards? How will preparers, auditors, and other participants in the financial reporting process be prepared for the transition? We believe the Board needs to consider a transition plan at the outset of this undertaking, while recognizing that it likely will become more informed as the principles-based approach moves forward.

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We commend the Board for its responsiveness concerning this important topic. We urge the Board, however, to address the issues carefully and thoughtfully so as to produce changes that will restore investor confidence in the financial reporting system.

Sincerely,

Barry C. Melancon President William F. Ezzell Chairman