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The attached comments are the personal viewpoints of the writer and do not necessarily reflect the opinion of the University of Connecticut or past employers. The opinions are based upon a career in public accounting (including a position as audit manager with Arthur Andersen & Co.) followed by 27 years in industry serving in both chief financial officer and/or operations officer positions in public and private companies. The opinions also reflect many years of service on Boards and Committees of the American Institute of CPA's and the Connecticut Society of CPA's.

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?

I support the Board's proposal for a principles based approach to standards setting as an objective to be implemented over a period covering the next several years. I do not believe such an approach can be implemented in the immediate future since the key parties involved need to implement significant changes in their activities and the processes required are not currently in place. My key concerns will be discussed in my response to question number 4 below.

If successfully implemented, a principles based approach will improve the quality and transparency of accounting and reporting. The financial reporting failures over the past couple of years have forced the accounting profession to "soul search" as to its root causes. While I do not believe the rules driven environment has been the key factor in the unfortunate recent events, it has played a contributing role. While the accounting

profession has defended the many individual rules, as individual "trees", the forest has burned down. Our "most trusted profession" has been damaged by case after case of publicized accounting failures. These failures have been the result less from rules than from the lack of resolve of all involved parties to defend the broader principles that provide for sound financial reporting. In particular, independent auditors have been defending their work as being prepared fairly in accordance with generally accepted accounting principles (GAAP). For decades now, ever since the landmark Continental Vending case (U.S. vs. Simon), the courts and users of financial statements have sent our profession a message that statements must be presented fairly - period, with GAAP being an inadequate defense. We have apparently not yet gotten the message. I believe that auditing firms have historically preferred a rules based system in order to more easily resolve accounting disputes with clients. The specific, yet arbitrary, rules have served as a crutch and road map to an end destination. Unfortunately, too often the road has wound up at the wrong conclusion. I believe that an emphasis on principles based accounting. while more difficult to implement initially, should enable us in the longer run to address the shortcomings of a reliance on too many rules driven pronouncements.

Finally, I believe that establishment of a principles based approach will allow for easier and more practicable harmonization of U.S. accounting standards with the rest of the world.

## 2. Should the Board develop an overall reporting framework as in IAS 1 and, if so, should the framework include a true and fair override?

Briefly, I agree that the Board needs to develop an overall reporting framework to provide the appropriate underpinnings for fair decision making. I am concerned, however, about the usefulness of a "true and fair override". If the Board truly establishes a broad principles based framework, I see this as a means of applying honest professional judgment. It seems to me that by definition professional judgment would allow unique application of principles without having to resort to an override. The existence of a

formally established override may unintentionally provide an excuse to waiver from a more appropriate financial reporting solution.

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 proving that guidance?

Interpretive and implementation guidance has to be provided to allow the resolution of honest professional differences of opinion that will undoubtedly arise, even with the adoption of clearly written principles-based standards. Even long followed and accepted principles may at times be subject to changes in interpretation as the underlying economic activities change and the business world becomes increasingly complex. As outlined in a book I have recently read<sup>1</sup>, even the U.S. Supreme Court, which heavily relies on established legal precedent, occasionally changes its interpretation of existing law despite long established case history. Certainly the accounting profession will need interpretive and implementation guidance. Such guidance, while hopefully not an undue and heavy burden on the profession, should not be limited, especially in the near term as broad principles are being implemented. The profession must provide the resources required to provide investor and creditor confidence in our reporting system.

While the Board should be the primary standard setter (with the utmost desire to maintain standard setting in the private sector) the Board alone does not have the human and financial resources alone to accomplish this goal. Despite recent publicly perceived problems (and self acknowledged shortcomings) with the American Institute of CPA's, I believe that they can play a key role in assisting the FASB is developing broad accounting principles. With membership well in excess of 300,000 covering public practitioners, industry, government and academicians, the AICPA can play a much needed role in providing both human and financial resources that will be necessary. I also believe that the establishment and acceptance of broad-based principles will require a broad based coalition that should establish task forces and guidance committees

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<sup>&</sup>lt;sup>1</sup> First Among Equals, The Supreme Court in American Life, Kenneth W. Starr, 2002.

consisting not just of AICPA members (including AcSec and others) but also, as appropriate in the particular circumstances, representatives from FEI, AIMR and other parties including industry associations. These groups could present their findings to the FASB with the hope that standards could be implemented on a timely basis. The intent is not to create a new beaurocracy that would inhibit timely guidance and implementation.

Finally, I would sincerely hope that a well functioning system such as briefly outlined above will allow the newly created Public Company Accounting Oversight Board (PCOAB) to delegate much of its responsibilities to the FASB and the private sector in general. Although Section 103 of the Sarbanes-Oxley Act of 2002 allows the PCAOB to adopt accounting standards, hopefully they will find the diligent efforts of professional accountants and other financial experts make PCOAB standards setting unnecessary.

## 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?

Herein lies the greatest challenge to implementation of a principles-based approach to standard setting. It also relates to my comments for requested response number one above. Near term implementation is impossible due to the required change in operation and even "mind set" of all above stated parties. It is important to discuss each of them, including the FASB.

I will start with the auditors for whom I have an admitted positive professional bias. Despite the extremely negative publicity of alleged audit failures over the past few years, I believe the auditing profession is in a good position to change over a short period of time. It has no practical alternative choice. It cannot financially survive an endless continuation of legal proceedings resulting from careless work product and continuing to do "business as usual". It must lead the change toward broad based standards that will restore the faith of the American public in our financial reporting system. It has been clearly demonstrated to me by the actions and words of large accounting firms in recent

years that independence in fact was the focal point of large auditing firms, at the disregard for *independence in appearance*. The lack of factual independence, while debatable, is not my point here. My point is that in the auditors' minds, in my opinion, they felt that as long as they determined they were factually independent, the appearance was not significant. That allowed them to engage in services for their clients that the public and many regulators have perceived as not being independent. It may also have influenced them to reach conclusions regarding the application of accounting principles in certain instances that at best were misguided. Auditors must change their mindset regarding the appearance of independence. Without this change, I do not believe that implementation of a principles-based approach can be successfully accepted by the users of financial reporting.

One reason that I believe that such change in auditor behavior is possible is the determination of the vast majority of CPA's, who have continuously been providing the highest level of quality service to the client and user communities, to restore public confidence in the profession. The carrot of restored and enhanced public confidence in the CPA, coupled with the stick of recently enacted reforms and penalties via the Sarbanes-Oxley Act, will cause change in auditor behavior.

One concern I have based on recent statements I have read or seen in the media, is a potential rush to weaken the tort reform related to financial statement preparers accomplished by the U.S. Congress during the nineties. As stated earlier, principles-based accounting standards require greater use of auditor judgment than rules based standards, not less. The legal environment must allow for application of honest professional judgment without the fear of monumental financial awards to plaintiffs, including punitive damages, as long as professional judgment is applied in good faith. Honest and intelligent young people will continue to enter the accounting profession as long as they see the recent problems as correctible within the profession. This will provide them with an opportunity to participate in the change process and provide new leadership for the profession. If they perceive an unfair litigious environment inhibiting honest

professionals from applying appropriate judgment, this will seriously harm the profession and the public interest.

The next group to examine is the preparer group. Even if we accept the premise that the vast majority of preparers are honest, certain situations exist that we must take into account with due consideration. The higher up the corporate management organization we consider, the greater the percentage of total compensation is comprised of incentive based compensation. This is desirable, primarily from the objective of achieving strong operating and financial performance for the company, as well as aligning management's goals with criteria that allow for increases in market performance of the stockholders' investment. In the real world, a CEO or CFO will continuously monitor his or her company's performance relative to their incentive based goals. Broad principles-based standards typically allow judgment to result in a range of accounting answers to financial reporting questions. The danger has always existed for improper financial reporting by preparers. The answer to the FASB question of "what needs to be done" requires a multipart answer. First of course is the need to set a "tone" at the top of each organization for honest and appropriate financial reporting. When improper reporting is discovered, executives must take corrective action. Earlier this year, the chairman and CEO of Dollar General Corp. repaid the company \$6.8 million for the value of vested options and bonuses he received during the period in which his company restated results due to accounting regularities.<sup>2</sup> As of this date, a similar problem still has not been resolved concerning the CEO bonus and financial reporting concerning Bristol-Meyers Squibb Company. Such issues should be resolved within each company's internal environment to ensure investor confidence in the fairness of financial reporting and corporate governance. If companies do not take the initiative, Section 304 of the Sarbanes-Oxley Act provides a remedy.

Another essential item that "needs to be done" for the preparer group is a more effective boards of directors, especially with respect to audit committees. Compositions of boards are changing. Universities across America are establishing courses and programs to

<sup>&</sup>lt;sup>2</sup> Dow Jones & Company, August 28, 2002.

financially educate board members. These changes should be monitored by organizations such as the SEC and the stock exchanges. Substantial improvements in financial education of board members and more truly independent board composition must be in place before a transition to principles-based standards can be successfully implemented.

Standards setters, including the FASB and SEC, also need to perform a self-examination as to what needs to change to allow principles-based standards to work. The independence in fact and appearance that the standards setters are demanding of the accounting profession must also apply to them.

The history of standards setting contains many examples of the appearance of political influence and lack of determination to clearly set standards. I will mention just a few. At a very early point in the life of the Accounting Principles Board (APB) an opportunity arose to set a principle that would be most appropriate for accounting for the Investment Tax Credit. My recollection from my study of accounting several decades ago is that two of the first four APB Opinions related to the ITC. Initially the APB agreed that the deferral method was the most appropriate way of accounting for the ITC. My recollection is that later the APB bowed to outside pressure and amended the rule to allow both the deferral method and the flow-through method.

A textbook I am currently using in teaching an accounting course makes the statement that "the FASB proscribed successful efforts accounting for oil and gas producing companies. The SEC disagreed with this approach and instead favored reserve recognition accounting. This led the FASB to reconsider and permitted the same alternatives to continue." The SEC and other appropriate bodies need to have input in the discussion stages for accounting standard pronouncements, but disagreements after publication by the FASB undermines the public's perception of fair and non-politically influenced standards.

<sup>&</sup>lt;sup>3</sup> Financial Statement Analysis, Wild, Bernstein, Subramanyam, McGraw-Hill Irwin.

Currently, the battle is raging over accounting for the expensing of stock options. While current standards require extensive disclosure concerning options and shareholder dilution, various companies are announcing their decisions to commence expensing of stock options when there is no agreement on the most appropriate method for doing so. A fear I have is that we will arrive at the most common method rather than the most appropriate method. This is not how accounting standards should be set. There is a present opportunity to arrive at an accounting standard for stock options that allows for objectively measurable and comparable results. This issue, due to its great exposure to the investing public and the media, needs to be resolved in a way that enhances investor confidence in financial reporting.

In summary "what needs to be done" will require unprecedented cooperation among preparers, users, standards setters and regulators. Until we make substantive progress in this area, free from undue political influence, creditors and other users of financial statements will justifiably continue to approach financial reporting with less than the desired confidence level needed for optimum performance of our capital markets.

## 5. Benefits and costs

I leave discussion on this topic to people far more able than I to quantify these items.

## 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?

While I believe the above commentary adequately covers my viewpoints on the issues raised, I will highlight key factors that the Board should consider in its deliberations on this subject:

There is a critical need to involve a wide range of viewpoints in this
deliberative process in order to adopt a policy to establish a principles-based
approach to setting accounting standards. This would encompass a broad

spectrum of users and other interested parties. However, once the process is adopted, the system will best function by letting the profession and the standards setters, including the SEC, do their jobs. Political influence in standards setting has rarely if ever produced positive results for the investing community, and should be resisted.

2. Finally, I wish to re-emphasize the great concern I have about the litigious times we live in. In a world of principles-based standards the use of professional judgment will result in different application of rules for seemingly similar sets of facts. Properly applied principles can result in high volatility of reported earnings, since our business environment is subject to economic cycles, significant changes within various industries, and the strong impact that results from a highly competitive business environment. Significant declines in reported earnings and stock prices could result despite accurate and honestly prepared financial reports. Preparers, auditors and other fiduciaries need some "safe harbor" to protect them from unreasonable legal actions. This issue may be beyond the powers of the Board, but it may be able to influence others that possess those powers.