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To: director@fasb.org

Re: Reference 1125-001 – Proposal for a Principles-based Approach to U S Standard Setting

The proposed principles-based approach to U S accounting standard setting depends for success on extensive exercise of professional judgment. Professional judgment in the conflicted U S accounting environment is a euphemism for client choice. Client choice is motivated by self interest. Self interest, when the stakes are high, always trumps professional judgment. Consequently, the proposed principles-based approach would not be acceptable for investor protection in U S capital markets.

Self interest is not the culprit. Self interest is the driver of the free market system. But when self interest conflicts with the public interest, regulation is necessary to ensure that markets are not only free but also fair. Accounting is a measurement instrument. Measurement instruments have been regulated – standardized – in the public interest since ancient times because the public demands fair measures. The essence of a standardized measurement instrument is that it produces the same measure wherever and by whomever it is applied. A scale measures 16 ounces per pound, not 15 ounces here and 17 ounces there. There is no choice.

There you have today's accounting problem. U S accounting standards, measurement standards, are rife with choice. There are endless opportunities to tinker with the accounting scale and tilt the measurement in the security seller's favor.

The real issue for U S accounting is not "principles-based standards"¹ versus "rules-based standards." That is the mantra of the same business community and accounting profession that earned us the Public Company Accounting Oversight Board, a government agency wearing a scanty private sector veil. The real issue is "no-choice principles" versus "free-choice standards."

¹ Aka "broad general" standards, meaning there is a range of possible interpretations.

I have written before in some detail on this subject in a letter dated July 5, 2002 and two letters dated July 24, 2002. I will summarize here some key points from those letters.

The existence of free-choice standards first became a public policy issue with the stock market crash of 1929. It took the accounting profession ten years after the crash to establish the Committee on Accounting Procedure, in 1939. It took the profession twenty more years to concede the failure of that Committee, attributable to inability to significantly reduce the body of free-choice standards. The Accounting Principles Board came next. It lasted from 1959 until 1973, failing again largely because of inability to significantly reduce the body of free-choice standards.

The Financial Accounting Standards Board took over in 1973. It acknowledged the problem of free-choice standards and undertook to develop a Conceptual Framework aimed directly at developing a principles-based approach to setting standards. *"The purpose...is to set forth fundamentals on which financial accounting and reporting standards will be based."*² Nonetheless, the Board has, in its turn, failed to significantly reduce the number of free-choice standards. The Board will follow its predecessors into oblivion, that is, into the maw of raw partisan-motivated government-dictated standards, if it does not come up with a way to eliminate free-choice standards.

In retrospect, it is clear that the Conceptual Framework had fatal flaws. The Board acknowledged the widespread existence of alternative methods and the need to make choices: *"...accounting information...entails choices between alternative accounting methods...The characteristics...discussed in this Statement are...a set of criteria for making those choices."*³ But the Board too readily accepted choice as indigenous to U S accounting and did not make elimination of choice a high priority. Instead it adopted a leisurely pace of change: *"The Board intends future change to occur in the gradual, evolutionary way that has characterized past change."*⁴ Perhaps more importantly, the Board stated that the concepts were not part of generally accepted accounting principles and thus did not have to be followed by accounting practitioners in the preparation and audit of financial statements. Thus, the concepts articulated in the Conceptual Framework, the closest thing to *fundamental principles* in the U S accounting model, were toothless.

The swampland of free-choice standards has had two consequences. First, it has subverted the standard setting process by changing it from a search for superior economic measurement methods (oriented to security buying investors) to a search for lobbyist-infested legislative-style solutions similar to the tax code (oriented to security selling corporations). Second, it has put undue, and

² SFAC 1, first paragraph following "Highlights."

³ SFAC 2, paragraph 5.

⁴ SFAC 5, paragraph 2.

seemingly irresistible, pressure on those auditors whose professional judgment is genuinely geared to the public interest as professional ethics mandates. Conversely, it has unduly reduced pressure on those auditors whose professional judgment is subordinated to self interest.

In my earlier correspondence I proposed a handful of basic principles for recognition, measurement, and display of financial information. Those principles would be similar in scope to some key concepts in the FASB's Conceptual Framework, but different in that they themselves would be standards – transcendent standards that stand on their own and require application even in the absence of implementation guidance. Their objective would be to eliminate choice as much as possible and thereby increase comparability. The objective would not be primarily to eliminate detailed standards although I believe they would have that effect to a significant extent.

In contrast, the IASB principles-based approach, as I understand it, would eliminate detailed standards, but it would increase choice in application because the standards would be broadly stated, requiring practitioners to apply the underlying principles without detailed guidance.

In my proposals, all assets and liabilities would be recognized if measurable and disclosed in detail if not measurable. There would be no such thing as an off-balance sheet liability or off-balance sheet entity. Asset and liability definitions would be tightened and expanded and become the focus of most standard setting guidance, revenue and expense guidance as well as balance sheet guidance. Fair value would be the objective for measurement of all assets and liabilities. Gains and losses would be segregated in the income statement.

Those principles would be mandatory and universally applicable to business enterprises, no exceptions. Future standard setting would then focus on refining the basic principles, asset-liability definitions most prominently, and applying them to particular circumstances. Many choices would be eliminated immediately and many more would be eliminated over time.

I also proposed that the standard setting process be streamlined, speeded up, and re-oriented away from the legislative format to a research format. In complex circumstances, I advocated, and I now underscore, that provisional standards, with minimal due process, be used to keep practice from deteriorating while full research-oriented deliberation is carried out.

I continue to believe those proposals would be helpful in eliminating free choice and its attendant manipulation potential. I will now address the specific questions posed at the end of your proposal.

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?

Answer: No. The proposal would lead to even greater choice, which is already the fundamental problem with U S accounting, and to greater diversity (less comparability), and eventually to more accounting scandals and probably to the demise of the FASB – the last remnant of accounting self-regulation in the U S.

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?

Answer: IAS 1 covers issues addressed in FASB Concepts Statement 5 and in principles 4 and 5 described in my letter of July 5, 2002. If IAS 1 has something useful that the FASB Conceptual Framework does not, then I would incorporate it. (I note, however, that information cannot be both neutral and prudent⁵, so do not fall into that trap.) I do not see any advantage to calling a Rule 203 opinion “true and fair” but if that is in the interest of convergence go ahead and refer it to the PCAOB – it is their jurisdiction now.

Under what circumstances should interpretive and implementation guidance be provided under a principles-based approach to U S standard setting?

Answer: The underlying premise of the principles-based approach is to rely on professional judgment. With that premise, implementation guidance is something of a contradiction. I guess the policy should be “Just say no!”

Should the Board be the primary standard setter responsible for providing that guidance?

Answer: I am dead certain that guidance will be required and will be given by someone, even with a “Just say no” policy in place. I believe guidance should be given by the FASB as long as it stays in existence, and probably by the PCAOB after that. Think about that - five lawyers setting accounting standards! The FASB, the last remnant of accounting self-regulation sucked into the vortex of investor outrage.

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?

Answer: Preparers will adjust easily and gleefully. Auditors, without specific guidance to help them resist outrageous client demands, will see

⁵ IAS 1, paragraph 20(b)(iii) & (iv).

professional judgment continue to run down hill (if not already at the bottom). The SEC will start setting more standards and find someone to take the load off their back. Maybe Standard & Poors will fill the vacuum. Analysts will rely on their black boxes and probably not even notice the change. Investors and creditors will rely on analysts. Everything will be fine until the next round of bankruptcies and accounting scandals.

What are the benefits and costs (including transition costs) of adopting a principles-based approach to U.S standards setting?

Answer: I cannot think of any benefits. The costs will be even more lack of comparability than we have now and an overall lessening in quality of financial information.

How might those benefits and costs be quantified?

Answer: They cannot be quantified. Both costs and benefits (if any) would be primarily intangible.

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?

Answer: The Board's life expectancy.

Disclaimer

I currently serve, on a contract basis, as Chairman of the Federal Accounting Standards Advisory Board. However, this memorandum expresses my personal views based on my experience with private sector standards and in no way intends to represent the views of the federal government or any federal agency. Further, my views are not intended to be applicable to governmental entities, federal, state, or local.

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