December 2, 2002

Dear Mrs. Bielstein:

BDO Seidman, LLP is pleased to offer our comments on the Proposal, Principles-Based Approach to U.S. Standard Setting. A summary of our major comments is as follows:

- The Proposal is unclear about what constitutes a principle and what constitutes a rule (implementation guidance).
- The Board creates an artificial dichotomy between principles-based and rule-driven standards. The highest quality standards are an artful blend of underlying principles and implementation guidance.
- Principles-based standards with little implementation guidance will create significant noncomparability, which will be costly to users of financial statements. Such standards also will create substantial costs for preparers and auditors to develop implementation guidance on a piecemeal basis.
- The criticisms of existing standards as overly rule driven are misdirected, and the causes of their complexity are broader than stated in the Proposal.
- The Board rightly identifies significant changes in behavior and attitude that would be necessary to make principles-based standards with little implementation guidance workable. There is little evidence that those changes are achievable or would be forthcoming.
- Standards with little implementation guidance create substantial potential for second guessing reasonable judgments, leading to unnecessary exposure for preparers and auditors.
Our letter begins with an analysis of the Proposal organized around the major comments identified above. Then we answer the questions raised at the end of the Proposal.

**Principles and Implementation Guidance—Not Well Defined**

The Proposal does not clearly define and distinguish what is a principle and what is a rule (implementation guidance). We thought we had a general sense of the definitions of the two terms, but the Board’s proposed redraft of FASB Statement No. 34, *Capitalization of Interest Cost*, in Attachment B of the Proposal is confusing to us. Consider the following two statements:

- Interest cost shall be capitalized as part of the historical cost of acquiring an asset that requires a period of time to bring it to the condition and location necessary for its intended use.
- Interest cost shall not be capitalized as part of the historical cost of acquiring inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis.

We would have thought that both statements are principles. The proposed redraft treats the first as a principle and the second as a rule, without any definition of terms or any discussion.

We also reviewed the principles-based evaluation of FASB Statement No. 87, *Employers' Accounting for Pensions*, prepared for the Financial Accounting Standards Advisory Council (FASAC). Page 3 of Attachment E-3 comments:

For example, the existing Statement contains a great deal of guidance specifying the acceptable actuarial approaches for determining the employer’s pension obligation. That type of guidance is beyond a principles-based standard. Instead, the guidance should permit actuaries to use their best professional judgment in estimating the employer’s pension obligation.

One of the Board’s fundamental decisions in Statement 87 was that the employer’s pension obligation at a point in time is the benefit attributed to the employees’ past service in accordance with the plan’s benefit formula. That fundamental decision led the Board to endorse the benefit attribution approaches and reject the cost attribution approaches. We would have thought the fundamental decision about the linkage of employee service to the employer’s obligation based on the plan’s benefit formula is a principle. The FASAC materials state that it is a rule.

If there is to be an intelligible discussion of the merits of moving to a principles-based approach to standard setting, there needs to be some common understanding of what the Board means. Without such a common understanding, different participants will use the
terms with different meanings, and it will be impossible to determine whether agreement exists. We do not mean to suggest that defining the terms and distinguishing principles from rules will be easy. In that regard, we recall a discussion with former Board member Robert Sprouse 20 years ago. Responding to then frequent criticism that FASB Statement No. 13, Accounting for Leases, was a “cookbook” of arbitrary and complex rules, Dr. Sprouse commented that FASB Statement No. 5, Accounting for Contingencies, was just as much a cookbook as Statement 13, but “the recipe is very simple.” We think most readers of the Proposal would consider Statement 5 to be a principles-based standard, but Dr. Sprouse suggested that it is a rulebook, albeit a simple rulebook.

For the remainder of this letter, we will use the terms principles and rules (implementation guidance) based on our understanding of the terms, recognizing that our understanding may differ from the understandings of the Board and other respondents.

**Principles and Implementation Guidance—Both Are Necessary**

The highest quality accounting standards are an artful blend of underlying principles and implementation guidance. Standards containing principles with little implementation guidance often fail to provide clear answers to specific questions. Such standards can result in substantial diversity in practice that is opaque to users of financial statements. At the other extreme, standards containing rules with no underlying principles render accountants incapable of answering questions that aren’t explicitly addressed, because no framework exists to analyze the questions. Further, rules with no underlying principles promote accounting for form over substance and create an environment that fosters what some might refer to as the “lawyering of accounting.” The right mix of robust underlying principles and implementation guidance achieves comparability and also provides a framework for analyzing questions that are not answered in the standard.

An example of a standard with principles but little implementation guidance is Chapter 4, “Inventory Pricing,” in ARB No. 43, Restatement and Revision of Accounting Research Bulletins. Chapter 4 contains the following principles:

- Inventory shall be carried at the lower of cost or market
- Cost includes both direct and indirect costs of bringing the article to its current condition and location
- Market means current replacement cost subject to a floor and a ceiling
- In certain rare cases, inventory may be carried at current sales prices in excess of cost
- Losses shall be recognized on firm purchase commitments, measured in the same way as inventory losses

Chapter 4 has little implementation guidance, (for example, which indirect costs to include in inventory costs, how to account for spoilage or excess capacity, or how to
aggregate inventory for purposes of measuring impairment). To the extent it provides implementation guidance, the guidance is so subjective that almost any method would be acceptable (for example, the aggregation of inventory for purposes of measuring impairment should be the method that "most clearly reflects periodic income"). The result is tremendous noncomparability, not just in terms of FIFO versus LIFO versus average cost, but also in capitalization of overhead and measurement of impairment. The cost method is disclosed in the notes to financial statements, and many LIFO enterprises disclose how earnings and assets differ from a FIFO basis. By contrast, there is little disclosure and no quantification of capitalization of overheads or aggregation of inventory for purposes of measuring impairment, making noncomparability in those areas opaque to users of financial statements.

Another example of a standard with principles but little implementation guidance is a hypothetical one—the standard for employers' accounting for pensions proposed in Victor Brown's dissent to Statement 87. Mr. Brown proposed a standard based on the principle that net pension cost should "be charged over the service lives of the existing work force such that the net pension cost would be a level percentage of current and expected compensation...." Furthermore, "Mr. Brown would leave implementation details to those who are aware of and can consider the circumstances of each plan situation." Exhibit B to the FASAC material referred to in the previous section similarly proposes that "the guidance should permit actuaries to use their best professional judgment in estimating the employer's pension obligation." The actuarial method and the assumptions would be left to the judgment of employers. Such a standard would result in less comparability among employers than Statement 87, and the differences would be opaque to users of financial statements. The Board noted in the Basis for Conclusions of Statement 87 that differences among actuarial techniques are complex and not well understood by users of financial statements and that users cannot readily approximate the effects of different methods. Further, the Board observed that in all of the research conducted by the American Academy of Actuaries, "the Board was unable to identify differences in circumstances that would make it appropriate for different employers to use fundamentally different accounting methods...." In our opinion, the pure principles-based approach to accounting for pensions would represent a substantial degradation in the transparency of reporting pension obligations. The other parts of the pure principles-based approach proposed to FASAC, eliminating offsetting and delayed recognition, would not mitigate the fundamental loss in transparency caused by diversity in measuring the employer's obligation.

Two examples of standards containing rules with no underlying principles are the former pooling-of-interest rules in APB Opinion No. 16, Business Combinations, and Statement 13. Both standards state a perfunctory principle, but the implementation rules bear little relation to the stated principle. In some cases, for example, FASB Interpretation No. 19, Lessee Guarantee of the Residual Value of Leased Property, the implementation rules are inconsistent with the stated principle.
We appreciate that the Proposal includes a redraft of Statement 34 to make clearer what the FASB means by principles-based standards with minimal implementation guidance. However, we believe a principles-based approach along the lines of the redrafted Statement 34 will create substantial diversity in practice, which will be confusing for users of financial statements, and also will impose high costs on preparers and auditors.

For purposes of discussing this point, we will focus in particular on the existing implementation guidance that is discarded:

- The Board would discard the definition of interest cost. We assume that under a principles-based approach, the Board also would eliminate the related discussions of the interest cost component of net periodic pension cost in footnote 4 of Statement 87, the interest cost component of postretirement benefit cost in footnote 8 of FASB Statement No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions*, and accretion expense in paragraph 14 of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, and in footnote 6 of FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. In the absence of this guidance, how would preparers and auditors decide what constitutes interest cost? The principles and “intent and spirit” of redrafted Statement 34 provide no framework for answering the question, “what is interest cost?”

- The Board would discard guidance on capitalization of interest cost with respect to investments accounted for by the equity method from FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*. The principles in redrafted Statement 34 provide no framework for answering the question, “how much interest should an investor capitalize on qualifying expenditures of investees accounted for by the equity method?” The basis for conclusions of Statement 58 explains that the guidance in Statement 34 was not clear and that many perceived a conflict between the principles in Statement 34 and the principles in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. All three approaches that the Board considered in Statement 58 were consistent in some respects with the principles of Statement 34 and Opinion 18, and the Board split 4 to 3 on the resolution.

If Statement 34 had been issued originally like the redraft, and had the Board not issued Statement 58, one of two costly outcomes might have occurred. One possible outcome is that each preparer would make its own decision about what to include as interest cost and how to capitalize interest on asset acquisitions by equity method investees from among...
the several methods that are compatible with the intent and spirit of Statement 34. Even if the decisions were disclosed as an accounting policy, the dollar effect of different decisions would likely be opaque to users of financial statements, imposing costs on them. (The AIMR letter quoted on page 1 of the Proposal lists comparability first as a desired characteristic of financial information.) The other possible outcome is that someone other than the FASB would have developed implementation guidance. Large, multilocation enterprises would have had to develop internal implementation guidance to assure that each location applied the standard consistently. In addition, perhaps our firm and other accounting firms would have been uncomfortable with different clients creating different definitions of capitalizable interest cost and would have developed internal definitions. It would be difficult for a single accounting firm to impose a definition on its clients if other accounting firms were accepting other approaches, so the accounting firms may have developed a consensus approach. The time and effort involved in developing and documenting policies at each large enterprise and accounting firm, let alone the time and effort in reaching and documenting a consensus, would have been costly. Then, rather than having the guidance conveniently retrievable to everyone through FASB Current Text, the guidance would be scattered in each entity's internal accounting policy manuals and perhaps in newsletters to clients.

Other paragraphs in Attachment C, for example, 11, 17, 19, and 20, provide useful guidance as well. Stripping that implementation guidance out of Statement 34 makes the standard shorter and simpler, but it does not make the accounting for capitalization of interest cost any less complex. The complexity arises fundamentally from the principle that interest should be capitalized, not from the implementation guidance. Preparers capitalizing interest cost and auditors testing the computations need an approach to address all of the issues for which the redraft gives no guidance. Taking the guidance out of Statement 34 doesn't make the issues go away.

**Misdirected Criticism of Existing Standards**

The introduction to the Proposal suggests that current accounting standards have too much rule-driven implementation guidance that allows financial and accounting engineering "around the rules." We think this criticism is misdirected.

- Some of the criticism arises from one high-profile business failure that involved numerous unconsolidated special-purpose entities, and the suggestion that the enterprise engineered "around the rules" to avoid consolidating those entities. As the investigations of that enterprise have proceeded, it transpires that the enterprise was unable to engineer around the rules, and that it entered into secret side agreements to conceal its noncompliance.

- Some of the criticism arises from disagreement over principles. The FASB has issued three pronouncements dealing with transfers of financial assets: FASB Statement Nos. 77, Reporting by Transferors for Transfers of Receivables with
Recourse, and 125 and 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. All three pronouncements have been based on the principles that (1) financial assets that are controlled by an enterprise should be displayed as assets and financial assets that are not controlled by an enterprise should not be displayed as assets and (2) if an enterprise is subject to risks related to noncontrolled financial assets, those risks should be recognized as liabilities. Some accountants and nonaccountants disagree with those principles and believe instead that if an enterprise is subject to substantial risks related to transferred, noncontrolled financial assets, that the transaction is in substance a collateralized borrowing. After an enterprise suffers losses arising from risks related to noncontrolled financial assets, some criticize the enterprise for inadequate disclosure of the risks or tardy recognition of the losses. Others, who disagree with the principles, criticize the exclusion of the assets from the balance sheet.

- Enterprises legitimately consider the financial reporting treatment when they decide whether to consummate transactions. If an enterprise prefers for business reasons to enter Transaction X, which has accounting consequence A, but would prefer accounting consequence B, the enterprise will explore what changes to Transaction X are necessary to achieve accounting consequence B. Whether the accounting standards contain implementation guidance or not, the enterprise will compare the disadvantages of changing the transaction to the perceived benefit of achieving accounting consequence B. Whether the accounting standards contain implementation guidance or not, it will be possible to substantively change a proposed transactions to give up control, obtain legal release from a creditor, legally isolate assets from the claims of creditors, purchase derivatives or insurance from independent parties, bring in a substantive independent investor, transfer risks or rewards of ownership or both, etc. to achieve different accounting treatment.

- Lack of timely implementation guidance for measuring fair value lies at the root of the problems revealed in the energy trading industry over the past year. For at least 15 years, accountants have been debating how bid-ask spreads should be reflected in fair value measurements and whether it is appropriate to record immediate dealer profits in a fair value environment. Although there were periodic requests for implementation guidance, the FASB chose not to provide any. Accountants had the principle that fair value "is the amount at which that contract could be bought or sold in a current transaction between willing parties" and a hierarchy of sources of fair value, but little implementation guidance on known issues where practice was diverse. The result was noncomparable accounting that was opaque to users of financial statements coupled with allegations of inappropriate fair value measurements. We believe that a neutral analysis of accounting and reporting failures would find as many, or more, attributable to lack of timely implementation guidance versus engineering around the rules.
Accountants from outside the United States who criticize U.S. standards as overly rules focused and tout the benefits of a principles-based approach generally operate in an environment with comparatively little oversight (no other country has a level of regulation and enforcement comparable to that provided by the Securities and Exchange Commission) and relatively benign litigation exposure. In addition, accountants outside of the U.S. often look at our implementation guidance when their own standards are unclear.

The Complexity of Current Standards

We believe the critique of the complexity of existing accounting standards in the Proposal is incomplete. The proposal identifies two sources of complexity—exceptions to the principles and interpretive and implementation guidance. We will give our reactions to those two reasons, identify other reasons that we believe contribute to complexity, and specifically give our views about why FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, is so complex.

Exceptions to principles. We agree that exceptions to the principles sometimes add complexity to accounting standards. However, we believe the Proposal’s explanation of why standards contain exceptions is a caricature of the Board’s due process (Board proposes standard based on principles drawn from the conceptual framework; self-serving constituents request exceptions to achieve desired accounting results, particularly to limit volatility of reported earnings; Board accommodates constituents) and is pejorative in attributing motives to constituents. Sometimes constituents in good faith disagree with a principle. Other times, a principle carried to its logical extreme creates results that are either hard to understand or contrary to the perceived economic substance of the transactions. In those situations, it is appropriate for the Board to make exceptions to the principle to achieve more understandable or representationally faithful results. For example, the Exposure Draft that preceded Statement 125 would have characterized many repurchase agreements as sales of the collateral rather than as collateralized borrowings. Perhaps some respondents objected to the earnings volatility that would result from treating the transactions as sales. We believe that many respondents objected because they believed that the economic substance of repurchase agreements was a collateralized borrowing, and they objected to an accounting result—a sale—that was so at variance to their view of the economic substance. The Board accommodated the concerns, even though that made Statement 125, and subsequently Statement 140, somewhat more complicated. Also, we think it is important to note that reporting volatility is not always representationally faithful. As the Board discussed in Statement 87, sometimes volatility reflects “an unavoidable inability to predict accurately the future events that are anticipated in making period-to-period measurements....Recognizing the effects of revisions in estimates in full in the period in which they occur may result in volatility of the reported amounts that does not reflect actual changes...in that period.”
Interpretive and Implementation Guidance. As stated in our discussion of the redrafted
Statement 34, we believe that interpretive and implementation guidance is a result of
complex accounting rather than a cause. If the principles create complex accounting or
the underlying transactions are complex, interpretive and implementation guidance is
needed to achieve reasonable comparability. If the Board does not provide the
interpretive and implementation guidance, the accounting will be just as complex, but the
costs and burdens of the accounting will fall either on users (to decipher noncomparable
accounting) or on preparers and users (to create the interpretive and implementation
guidance on an ad hoc, piecemeal basis).

We believe that there are more significant causes of complexity that the Proposal does not
discuss—complicated principles, conflicting principles, conflicting implementation
guidance, and inconsistent transition provisions.

Complicated principles. Sometimes the principles on which a standard is based are
inherently complex to implement. For example, the underlying principle in Statement 34
that interest should be capitalized is inherently complex and requires enterprises to
identify interest cost and asset acquisitions and allocate interest cost to the qualifying
assets. The alternative principle of charging all interest cost to expense would be less
complex. As another example, the underlying principle in Statement 13 is that “a lease
that transfers substantially all of the benefits and risks incident to the ownership of
property should be accounted for as the acquisition of an asset and the incurrence of an
obligation by the lessee....All other leases should be accounted for as operating leases.”
This principle inherently requires guidance to identify leases that transfer “substantially
all of the benefits and risks.” The Board considered, but did not adopt, a principle that
would have been simpler to implement—that all leases convey to the lessee economic
rights to use the property that meet the definition of an asset and obligations to pay the
lessor that meet the definition of a liability. That principle would have been simpler to
implement, and would have required less implementation guidance. (It also would have
been then, and would still be today, unacceptable to many of the Board’s constituents.)
Our point is that often the complexity arises not from the exceptions to the principles, but
from the principles themselves.

Conflicting principles. The Board creates substantial complexity when it adopts different
principles for accounting for similar transactions. For example:

- The recognition principles for employee severance benefits are different for an
  ongoing plan under FASB Statement No. 112, Employers’ Accounting for
  Postemployment Benefits, versus one-time benefits under FASB Statement No.
  146, Accounting for Costs Associated with Exit or Disposal Activities. Not only is
  this difficult for accountants to understand and remember, it also requires
  accountants to assess whether an apparent one-time severance benefit is part of a
  pattern that constitutes an ongoing plan.
• The principles for recording a sale of financial assets under Statement 140, which are based on loss of control, are inconsistent with the principles for recording a sale of nonfinancial assets, which are based on transfer of risks and rewards of ownership. This creates uncertainty when the asset has attributes of both, for example, an equity method investment in a real estate entity.

Conflicting implementation guidance. The Board creates substantial complexity when it addresses implementation issues inconsistently among standards. For example:

• An investment accounted for by the equity method is a nonmonetary, productive asset in APB Opinion No. 29, Accounting for Nonmonetary Transactions, but is a financial asset in Statement 140. Further, the assessment of impairment for an investment accounted for by the equity method is a unique method set forth in Opinion 18 that differs from the assessment of impairment for other productive (long-lived) assets under FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, and for financial assets under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.

• The Board specifies different aggregations of assets for different types of transactions. For example, under FASB Statement No. 131, Disclosures about Segments of an Enterprise and Related Information, an enterprise identifies operating segments. Under Statement 144, a component of an entity constitutes a discontinued operation. But under FASB Statement No. 142, Goodwill and Other Intangible Assets, impairment of goodwill is measured for a reporting unit.

• The accounting literature contains a multitude of different recognition triggers and measurement methods for impairment of different kinds of assets.

• The implementation guidance about splitting versus aggregating contracts is inconsistent. For financial instruments, the implementation guidance generally requires entities to account for contracts separately, and even to split single contracts into components. For nonfinancial contracts, particularly in the area of revenue recognition, the implementation guidance generally is the opposite—to aggregate separate contracts into a single transaction.

These inconsistencies greatly increase the complexity of accounting standards.

Inconsistent transition provisions. It sometimes seems like the 148 FASB Statements have 148 different transition methods. We know this is an exaggeration, but there certainly is diversity in terms of prospective versus retroactive application, required adoption in the first quarter versus any quarter, early adoption encouraged, permitted, or prohibited, etc.

Statement 133. The Proposal cites Statement 133 as an example of a complex standard with voluminous implementation guidance. This is certainly true. We believe the complexity arises from two principal causes—the broad scope and the Board’s ambivalence about special hedge accounting.
• **Broad scope.** We think most accountants and businesspeople would identify forward contracts, futures, swaps, and options as derivative instruments. We believe the Board was concerned during the development of Statement 133 that enterprises would attempt to circumvent Statement 133 by calling derivatives by different names (for example, foreign currency insurance rather than foreign currency option) or by embedding derivatives in nonderivative instruments. To avoid this, the Board defined derivative instrument very broadly. The broad definition had the consequence of sweeping in a host of long-standing, traditional contracts, like inventory purchase contracts and loan commitments, that few had ever thought of as derivatives, and others like callable debt, that few had ever thought of splitting. The FASB then developed complex rules, some in the Statement and others developed by the staff with the assistance of the DIG, to exclude transactions from the scope or from the requirement to split (bifurcate) the embedded derivative. We think a no-exceptions, principles-based approach of treating most inventory purchase contracts and loan commitments as derivatives and requiring the bifurcation of the call option in every issue of callable debt would be every bit as complex to implement as Statement 133 is.

• **Special hedge accounting.** The Board accepted special hedge accounting in Statement 133 because of the accounting anomalies identified in paragraph 320, but it seemed to be a reluctant acceptance. Conversations with individual Board members indicated that some perceived widespread abuses in the application of special hedge accounting under the predecessor standard, FASB Statement No. 80, *Accounting for Futures Contracts*. The result is that the criteria for applying hedge accounting, the exposures to which hedge accounting may be applied, and the procedures for implementing hedge accounting are spelled out in much greater detail in Statement 133 than they were in Statement 80. We think an approach more like Statement 80 would have been workable, but the Board was uncomfortable with that. An approach of eliminating special hedge accounting would reduce complexity, but we believe the resulting accounting anomalies would make the financial statements less understandable to preparers and users of financial statements.

**Necessary Changes in Behavior and Attitude**

The Board rightly identifies significant changes in behavior and attitude that would be needed to make a system of broad principles with little implementation guidance workable. The Board notes, and we agree, that practice would become more diverse as a result. Different accountants applying professional judgment in good faith will reach different conclusions when applying broad principles to specific transactions. We noted previously specific examples relating to capitalization of interest where the broad principles would not specify a particular approach to identifying interest cost or capitalizing interest for asset acquisitions by equity method investees. However, we are
not confident that regulators and the plaintiff's bar will accept such diversity in practice, particularly after a business fails. We see today, even with extensive implementation guidance, after-the-fact criticism of accounting for transactions that generated revenues or gains for enterprises that later failed. In some of these cases, there may be valid criticism that transactions not in the normal course of business were not accounted for or disclosed appropriately, thus masking deterioration in the enterprise's principal ongoing business. In other cases, however, the critics seem to suggest that the accountants should have known that the business was failing and should not have allowed the recognition of revenues or gains that gave an appearance of financial health, regardless of the merits of the accounting.

The Proposal reflects the view of many proponents of principles-based standards that the economic substance of transactions is clear, and that if we can only clear away the rules and implementation guidance, accountants will be able to use their professional judgment "to more clearly convey the economic substance of transactions and events." In many cases this is unrealistic. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, notes that "Substance over form is, in any case, a rather vague idea that defies precise definition." The economic substance of many transactions is in the eye of the beholder. Accountants in good faith disagree vociferously over the economic substance of many transactions, for example, whether some leases are in substance installment purchases of the leased property, whether sales of receivables with recourse are in substance collateralized borrowings, whether split-dollar life insurance is in substance a non-interest-bearing loan to the employee, whether the unallocated shares in a leveraged ESOP are in substance the employer's treasury shares, etc. With minimal implementation guidance, more diversity in practice will emerge, and after-the-fact litigation about the economic substance of transactions will proliferate.

We believe that economic substance over legal form is an important principle for accountants. It emphasizes to accountants that they always should understand the economic substance of a transaction before evaluating the proper accounting. If a transaction does not seem to make economic sense, the accountant understands that he or she may not have all of the facts—that is, the parties may have additional rights or obligations, some perhaps unstated—and needs to investigate further. In certain abusive transactions, we think a majority of accountants would agree on the economic substance of transactions. However, we do not believe that sufficient agreement exists on the substance of many conventional transactions to achieve an acceptable level of consistency and comparability based only on substance over form. We also note that the Board and staff have on a number of occasions elevated form over substance, for example:

- The implementation guidance on accounting for leases often elevates form over substance. Interpretation 19, previously mentioned in this letter, is a particularly egregious example. The whole phenomenon of "synthetic leases" would not exist had the Board resolved Interpretation 19 based on economic substance.
• DIG Issue A9, *Definition of a Derivative: Prepaid Interest Rate Swaps*, states that prepaid swaps are derivatives in their entirety, whereas many accountants previously viewed them in substance as financings with an embedded derivative. Issue A9 provided authoritative support for treating prepaid commodity swaps in the energy industry as derivatives in their entirety rather than as debt with an embedded derivative.

• DIG Issue C16, *Scope Exceptions: Applying the Normal Purchases and Normal Sales Exception to Contracts That Combine a Forward Contract and a Purchased Option Contract*, states that the accounting would be different if the parties entered into two separate contracts rather than one, even though the economic rights and obligations are identical. Paragraph A10 of FASB Interpretation No. 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of Others*, similarly states that two separate contracts are disclosed differently than a single contract with identical rights and obligations.

*What Do We Recommend?*

We have explained in this letter the reasons why we do not support the Board’s proposal for principles-based standards with minimal implementation guidance. However, implicit in our comments are some suggestions for reducing the complexity of accounting standards and making them easier to understand, remember, and implement.

• *Make simplicity one of the considerations in establishing new standards.* The Board should make simplicity one of its considerations in making decisions on new accounting standards. Today, simplicity is not a consideration. Reading the bases for conclusions, one finds that the Board makes decisions based on fidelity to the conceptual framework and the perceived usefulness to users of financial statements. Simplicity is not even noted as a consideration. Just as the Board makes trade-offs between relevance and reliability, the Board should make trade-offs between simplicity and other objectives.

• *Use existing or familiar principles, classifications, asset groupings, computations, etc. whenever possible.* When the Board addresses an issue that has precedents or parallels elsewhere in the accounting literature, we suggest a presumption that the Board build on the precedent or parallel unless a new classification, asset grouping, etc. has a substantial benefit. If the Board identifies a substantial benefit from introducing a new classification, asset grouping, etc., consider amending the prior requirements to conform, thereby maximizing the internal consistency of GAAP and minimizing the number of different requirements for accountants to remember.

• *Amend existing standards to eliminate inconsistencies in principles, implementation guidance, computations, asset groupings, classifications, etc.* For example, choose one asset grouping for purposes of segment reporting,
impairment of goodwill, and discontinued operations; develop a handful (fewer than five) of asset impairment models and conform the existing impairment guidance to one of the standard methods; and eliminate the differences in employers' accounting for one-time versus recurring employee compensation.

- **Standardize transition methods.** It would simplify the lives of both the Board and its constituents to develop a handful (fewer than five) of standardized transition methods and criteria for the use of each one.

**Responses to the Questions in the Proposal**

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?** No, we do not support the proposal for stripping away implementation guidance and placing primary reliance on broad principles. As described previously in this response, we believe the result of that approach will be greater diversity in practice, less transparency, and higher costs for users, preparers, and auditors. We believe the Board’s objective should be standards that artfully blend underlying principles and implementation guidance.

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?** We don’t have a strong view about whether the Board should develop an overall reporting framework like IAS 1. Some of the content of IAS 1 already exists in U.S. accounting standards, auditing standards, or FASB Concepts Statements. As a result, we don’t think such a framework would significantly improve U.S. reporting. However, we strongly oppose the true and fair view override. Rule 203 of the AICPA Code of Professional Conduct represents the equivalent of a true and fair view override. It is almost never invoked. True and fair view, or fair presentation, is, like substance over form, “a rather vague idea that defies precise definition.” Inevitably, such an override is an invitation to accountants to substitute their judgment for the standard-setter’s judgment. No objective benchmark exists by which an enterprise or its auditors could decide that complying with a standard would be misleading. Instead, we believe that the fairness of presentation should be debated during the development of a standard. The Board and its constituents should consider whether valid principles carried to logical extremes might create confusing or misleading results. However, once the Board makes a final decision, we are uncomfortable with empowering individual accountants to override the Board’s judgment.

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 providing that**
We believe that interpretive and implementation guidance should be provided if the broad principles permit an unacceptably wide range of diversity in practice or if the diversity in practice is not transparent to users of financial statements. We believe substantial interpretive and implementation guidance will continue to be needed. To the extent the need for guidance is identified during the development of a standard, the FASB should provide the guidance. However, to the extent the need for guidance arises after a standard is issued, the Board should delegate to the EITF. The Board will likely be overwhelmed and consumed if it attempts to provide all of the necessary guidance itself.

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? As we stated previously, we are not confident that the SEC, other regulators, or the plaintiff’s bar will adjust to a principles-based approach to U.S. standard setting. The Board does not have the power to change their incentives nor to change human nature. In the unlikely event that those groups would adjust, by accepting greater diversity in practice and good faith differences in judgment, then the other parties could adjust. As noted previously and in answer to question 5, we believe that adjustment by the other parties will be costly to them.

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? As noted previously, we see negligible benefits and substantial costs for users, preparers, and auditors. Users will incur costs to identify and quantify diverse practices. Preparers and auditors will incur costs to create and retrieve interpretive and implementation guidance and to respond to lawsuits second guessing judgmental applications of standards with little implementation guidance. With respect to quantifying these costs, perhaps users could estimate the time and effort they incur currently identifying and quantifying differences in accounting for areas that have principles-based standards now, for example, inventory and property, plant, and equipment. Users might then extrapolate to the time and effort they will incur, as diversity in other areas of accounting increases to the level that currently exists for inventory and PP&E. Perhaps large enterprises and auditors could estimate how many people they will have to devote to replacing the interpretive and implementation guidance that the FASB and other standards setters currently provide. We do not know how to estimate the cost of additional litigation; we believe it will be significant.

We would be pleased to discuss our comments with the Board or the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661.
Very truly yours,

s/ BDO Seidman, LLP