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Director of Major Projects and Technical Activities  
File Reference No. 1125-001  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856

Re: Proposal for a Principles-Based Approach To U.S. Standard Setting

We are pleased to respond to the Financial Accounting Standards Board's (FASB's) Proposal for a Principles-Based Approach to U.S. Standard Setting dated October 21, 2002 (the "Proposal").

Earlier this year, we called for the profession to move to a principles-based approach to setting standards in order to foster accounting that is driven not by the form a transaction takes but by its substance. We believe the current process by which standards are set has had the opposite outcome and has resulted in standards that are incredibly complex, difficult to implement and, in some cases, obscure the economics of transactions subject to those standards. Consistent with the view we expressed earlier this year, we are in favor of moving to principles-based standards. However, we have a number of comments for the Board's consideration, in addition to some concerns that we believe need to be addressed for a move to principles-based standards to succeed. We believe that the following actions are necessary to effect the move to principles-based standards:

- Clarification of what is intended by the phrase "principles-based standards" so all constituents have the same understanding.
- Acceptance of principles-based standards by the Securities & Exchange Commission (SEC) and other regulatory agencies. We understand that the SEC plans to study how it can operate in a principles-based standards environment without putting registrants at a disadvantage.
- An independent study of the International Accounting Standards Board's (IASB's) process for developing principles-based standards by a group of preparers, auditors, and users should be conducted for the purpose of understanding the reasons for the number of interpretations issued by the Standing Interpretations Committee (SIC) of the IASB, as well as the reasons for the significant volume of implementation guidance provided by the IASB staff on IAS 39, *Financial Instruments: Recognition and Measurement*. The FASB could use that study to ensure that it benefits from the experience of the IASB. One advantage of principles-based standards should be a reduction in the need for interpretive guidance since preparers and auditors will be required to determine the appropriate accounting based on the substance

of the transaction and considering the overarching principles in the standards as opposed to applying a cookbook of rules.

- A change in the FASB's process for issuing new standards to require field-testing of proposed standards using a broad cross-section of companies, not just the Fortune 500, to identify any unintended consequences before a standard is issued. The FASB should not issue a new standard until there is a determination that preparers are able to apply the standard in a manner consistent with the Board's intent.
- Improvements to the financial reporting model to make financial information more useful to users of the information. Financial reporting needs to provide timely, reliable and relevant information. Moving to a principles-based approach is only a partial solution if the financial reporting model is not improved.

The remainder of this letter amplifies on the points above and responds to the specific questions in the Proposal.

#### *Clarifying what is intended by "Principles-Based Standards"*

Although there has been much public discussion about principles-based standards, there has not been much discussion about what exactly is meant by the phrase "principles-based standards." We believe the phrase "principles-based standards" refers to a broad spectrum, ranging from standards that only contain broad principles and no implementation or application guidance on one end to standards that contain the same broad principles but very detailed implementation and application guidance on the other. We believe the approach to principles-based standard setting that the FASB should strive for is one that provides adequate explanation of the standard in plain English so it is capable of being understood and appropriately applied by accountants generally, not just those who are experts in specialized areas such as securitizations or derivatives.

The FASB's revision of Statement No. 34, *Capitalization of Interest Cost*, leads us to believe that the Board will attempt to achieve a balance between not enough and too much in provided guidance that would assist preparers and auditors in applying the principles. We are not sure whether the Board went through an in-depth process to come to the revised Statement 34, but we identified certain paragraphs that were omitted from the revision that provide guidance on applying the principles and are not sure why those paragraphs were omitted. Specifically, paragraphs 14, 15 and 17 provide guidance on determining the capitalization rate, determining the amount of interest cost when a subsidiary reports separately as well as in consolidation, and interpreting "activities" for purposes of deciding when to begin or suspend interest capitalization, respectively. In addition, we would have expected the Board to provide application guidance on how interest cost is to be determined. Without a definition, one company could conclude that interest cost should be net interest expense for the period, another could conclude it should be gross interest expense (except when certain tax-exempt borrowings are used), and a third could conclude it should be gross interest expense (ignoring tax-exempt borrowings).

Ideally, the result of the standard-setting process should be standards with clearly articulated principles, few (if any) scope exceptions, and application guidance that assists preparers and auditors in implementing the principles.

*Acceptance of Principles-Based Standards by the SEC and other regulatory agencies*

As noted in the results of the 2002 Annual FASAC Survey, some FASAC members observed that, for principles-based standards to become a reality, the SEC would need to support the initiative. We believe there are two elements to that support. First, the SEC (and other regulatory agencies) would need to resist the urge to require specific accounting for transactions that are within the scope of a principles-based standard. FASAC members acknowledged that a move to a principles-based approach that requires the exercise of judgment by the preparer and auditor could result in similar transactions being accounted for differently by two entities. If the SEC staff or other regulators do not resist the urge to step in and require specific accounting treatment, we believe the move to principles-based standards will ultimately not succeed as more rules are imposed by sources external to the FASB. If the SEC or other regulatory agency observes inconsistencies in the application of a principle to similar transactions, it should discuss those inconsistencies with the FASB. To the extent the inconsistencies do not result from the inappropriate application of the principle, the FASB may consider whether the principle is still appropriate and, if so, whether additional disclosures may be necessary to assist users in understanding the different potential outcomes that may result from the application of the principle.

The second element to this point is that preparers and auditors are understandably concerned with second-guessing by the SEC staff. An acknowledgment by the SEC staff that preparers and accountants who reach a reasoned conclusion on the application of the principle after analyzing the substance of a transaction will not be subject to second-guessing, even when that reasoned conclusion is not the first choice of the SEC staff, will go a long way toward helping accountants adjust to a principles-based environment.

*An independent study of the IASB's process*

Since the IASB has used a principles-based approach in setting its standards, we believe the FASB, through an independent committee comprised of preparers, auditors, and financial statement users, should study the results of that approach. Specifically, the committee should consider the reasons why it has been necessary for the SIC to issue the number of interpretations it has issued and why it has been necessary for the IASB staff to issue implementation guidance on IAS 39 that has more than 200 issues, excluding issues arising with respect to the Statements' effective date and transition. In Sir David Tweedie's testimony before the Senate Banking Committee, he indicated that the hope of the IASB through the principles-based approach to setting standards is that "a clear statement of the underlying principles will allow companies and auditors to deal with those situations [individual transactions and structures that are not specifically addressed] without resorting to detailed rules." Given that goal, it is critical to the FASB's implementation of a principles-based approach to understand whether the interpretations and implementation guidance are the result of unclear principles, insufficient explanation of the principles so that preparers and auditors were not able to understand the IASB's thought-process in developing the principle, or other shortcomings in the approach being followed by the IASB so that those shortcomings are not repeated, or whether the interpretations and implementation guidance may be a result of a realization that the principles-based approach to standards setting does not work as it is intended.

*Changing the FASB's process for issuing new standards*

We believe the FASB needs to change its process for issuing standards to include field-testing of proposed standards involving a broad cross-section of companies before final issuance. Field-testing proposed standards will allow early identification of standards that are incapable of practical implementation, as well as unintended consequences of applying the principles in practice. While the Board's current process for issuing standards sometimes results in the use of task forces and roundtable meetings, we do not believe task forces and roundtables are an adequate substitute for the hands-on experience the Board and its staff would obtain in trying to implement proposed standards through a field test.

We feel strongly that the Board should involve smaller companies in field-testing its proposed standards and not just focus on the Fortune 500. In recent years, the Board has moved to issuing standards that have highly complex or inadequately clarified terms that smaller companies, given their limited accounting resources, have almost no hope of being able to implement in the manner required by the standard. In those circumstances, companies are left with the choice of either accounting for transactions in a manner that does not reflect the economics or not entering into transactions that make sense from an economic perspective because of the hurdles to complying with the accounting standard so that the accounting appropriately reflects the economics. For example, FASB Statement No. 133, *Accounting for Derivatives and Hedging Activities*, as amended, includes detailed rules for obtaining "special" hedge accounting for a derivative instrument that reduces a company's economic exposure to changes in cash flows or fair values of assets, liabilities, firm commitments or anticipated transactions. Missing even one seemingly innocuous part of one of its myriad of requirements leaves a company with accounting that forces volatility into the financial statements that does not exist from an economic perspective. We find that result to be inconsistent with a principles-based approach that, as stated in the Proposal, "should more clearly convey the economic substance of the transactions and events covered by the standards."

*Improving the financial reporting model*

While this issue may not seem directly related to the consideration of moving to a principles-based standard setting approach, we believe the current reporting model is in need of repair to make financial statements more user-friendly and provide information that is timely, relevant and reliable. Once the Board has considered what changes need to be made to the financial reporting model, it should then consider how setting standards using a principles-based approach interacts with that reporting model. For example, if the Board adopts standards with broad principles and minimal implementation or application guidance, it would need to consider what information would be relevant to users in comparing companies' financial results and how that information can be provided without creating (or adding to the present issue of) disclosure overload.

With respect to the specific questions raised in the Proposal, we offer the following thoughts:

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?*

As stated previously, we support adopting principles-based standards that clearly articulate a principle, do not include numerous exceptions, and provide application guidance that shows the spirit and intent in which the Board intended the principle to be applied, similar to what is contained in the Basis for Conclusions in standards issued today. The clear articulation of the principle and the application guidance should be sufficient to enhance the ability of preparers and auditors to consistently apply the principles. We strongly believe the principles should be clear and should be written in plain English and avoid jargon, something that is not consistently found in today's standards. Two examples of standards that fail these criteria are the recently issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, and the proposed FASB Statement, *Accounting for Stock-Based Compensation – Transition and Disclosure*. The former includes a scope section that is overly complex and difficult to comprehend, while the latter includes a description of the modified prospective method that would not be immediately understood to mean the same thing as the description of that method in the Basis for Conclusions.

While we believe a principles-based approach to setting standards, if done correctly, will improve the quality of financial accounting, we are unsure as to whether it will improve the transparency since it is possible, under a principles-based approach, for similar transactions to be accounted for differently. While we believe it is incumbent on standard setters to develop standards with principles so clearly articulated that the intent and application will be evident, we believe there may be transactions for which unbiased judgment could reach different conclusions. The potential lack of transparency in these situations will be an issue from the perspective of users of the financial statements. Transparency may be achieved by expanding the required disclosures; however, that solution will then place even more pressure on a financial reporting system that already suffers from disclosure overload. We believe improvements in financial reporting will be driven by what the FASB decides to do in its separate project on financial reporting, as well as by a move to principles-based standards.

Lastly, we believe that the Board could take a relatively small step at the current time that would improve accounting by eliminating special scope exceptions that are not required because of other authoritative literature that addresses the item subject to the scope exception and that are not conceptually based. For example, in its proposed interpretation on consolidation of special-purpose entities, we understood the principle to be that the primary beneficiary's financial statements should include those assets it controlled and liabilities it was obligated to pay. However, the Board concluded that the primary beneficiary should not consolidate assets and liabilities included in the balance sheet of a substantive operating entity (or voting interest entity) simply because of the form of the arrangement (e.g., held on the balance sheet of the substantive entity as opposed to being held in a separate legal entity that was owned by the substantive entity). If the Board truly believes transactions with similar economics should be accounted for in a similar manner, it should identify the

principle it believes is important and eliminate the special scope exceptions that promote accounting that is not consistent with the underlying principle in the standard.

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 do not believe the Board needs to undertake a comprehensive project to develop an overall reporting framework similar to what is contained in IAS 1. However, we do believe the Board should consider what changes are necessary to enhance the usefulness of financial statements to users and ensure that any changes that might be made in moving to a principles-based approach to setting standards does not reduce the usefulness of financial statements. If the Board chooses to pursue development of an overall reporting framework, we believe it should not include a true and fair view override. If anything, there should be less reason for a departure under a principles-based standard than under a rules-based standard since the preparer is accounting for the substance of the transaction. We are not persuaded by the rationale for including the true and fair view override in IAS 1 since the override may only be used when a principle is considered clearly inappropriate. When a standard is principles-based, it would seem that an inappropriate principle would be identified and removed prior to the issuance of the standard.

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 guidance?*

We believe guidance that will assist in the application of the principles contained in the standard should be provided by the Board in all standards it issues. The Board does not tend to address issues that are straight-forward where simply stating the principles will be sufficient for preparers and auditors to apply the standard. As such, guidance that allows preparers and auditors to understand what the Board was thinking when the principle was identified would be helpful. We also believe examples of applying the principles would be useful in promoting consistency in the application of those principles. This will be critical in the future as the accelerated reporting deadlines imposed by the SEC will increase the pressure on companies, but in particular smaller companies, to address routine tasks, giving them less time to analyze complex, unclear, and jargon-filled standards.

With respect to interpretive guidance, we believe that the need for interpretive guidance should be infrequent if the principles-based standards are developed in an appropriate manner, which is why we believe an independent committee should consider the reasons for the number of interpretations and implementation guidance deemed necessary after the issuance of principles-based standards by the IASB. To the extent issues arise that do not clearly fit the principles enunciated in a standard, we believe the FASB should continue looking to the EITF to provide timely guidance on applying the principles to those issues.

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?*

We believe preparers and auditors will adjust to a principles-based approach if the SEC agrees to accept that differing interpretations of the principles may result in similar transactions being accounted for differently and that both results may be reasonable and, along with other regulators, is able to resist the urge to legislate its own views. Further, in order for preparers and auditors to adjust, the FASB must write standards that are clear and must show an ability to be able to strike a balance between no application guidance and guidance that results in rule-filled cookbooks.

We are concerned about whether users of the financial statements will be able to adjust to a principles-based approach, particularly if that approach has the potential to result in different entities applying different accounting for the same transaction. As noted in the Association for Investment Management and Research February 2000 letter, “[t]he lifeblood of United States capital markets is financial information that is: (1) comparable from firm to firm ....” Accordingly, we believe the Board should consider what implications the principles-based approach has had for analysts who follow European companies that have adopted IAS standards.

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?*

We believe the benefits of adopting a principles-based approach to standard setting include accounting that reflects the substance of the transaction instead of its form and a reduction in the amount of time spent discussing the appropriate accounting for transactions that currently occurs because of the myriad of rules that potentially apply to a particular transaction, some of which result in significantly different accounting conclusions, and that need to be considered by preparers and auditors. A principles-based approach will also hopefully reduce the sometimes significant efforts to structure transactions to obtain a different accounting result.

With respect to potential costs, we believe the Board will bear the greatest cost as it attempts to address the issues it has already committed to address and, at the same time, begin the process of converting to principles-based standards. We believe the Board will also need to spend time field-testing its proposed standards, developing plain English principles, and providing sufficient implementation guidance, all of which may have the effect of lengthening the period of time it takes to issue a new standard.

As part of that process of converting existing standards to principles-based standards, we believe the Board needs to consider the different principles underlying similar sets of transactions and decide which principle should be retained. For example, real estate sales follow a principle that derecognition is appropriate when substantially all of the risks of ownership have been transferred to the buyer, while receivable securitizations follow a principle that derecognition is appropriate if the transferor no longer has control over the transferred assets. Two different standards containing two different principles to deal with the same fundamental issue of derecognition by an entity of assets it owns will not be acceptable if a move to a principles-based approach is to be successful. Recognizing that

more and better information may result in the development of superior principles, we understand that the FASB cannot be bound to a principle for eternity. However, when a superior principle is identified, we believe all prior standards that involve the same fundamental issue should be conformed to the new principle. Reducing the number of different principles that deal with the same issue will result in an improvement in accounting because it will help in reducing standards overload, some of which is caused by keeping track of different models used to account for similar issues. Preparers and auditors will bear the cost of re-educating people to learn the new standards.

We believe the Board could best quantify the benefits and costs by looking to the experience of companies in European countries such as Germany that have detailed rules since those companies will be required to adopt IAS standards by 2005.

Finally, with respect to transition costs, we believe applying principles-based standards prospectively would be less costly than requiring retroactive application, to the extent such retroactive application was even possible. We believe this is particularly so, when the Board will be issuing new standards and revising existing standards to conform to the principles-based approach over a number of years, to avoid perpetually restating financial statements to apply the new (or revised) standards. While comparability may be impaired by that approach, restating the financial statements every year for new or revised standards when those standards will be issued over an extended time period is an expensive proposition.

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?*

The FASB should consider what impact the convergence of standards will have on the adoption of principles-based standards. To the extent the IASB adopts standards based on U.S. standards in areas where either the U.S. standard is considered preferable to the equivalent IAS standard or no IAS standard exists, the costs of moving to a principles-based approach will increase. The Board should also consider other existing literature such as AcSEC and EITF pronouncements that will need to be conformed to a principles-based approach or superseded. Lastly, we believe the FASB should consider whether it has sufficient resources to keep up with its existing projects and move to a principles-based approach on a timely basis and in an effective manner.

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We would be pleased to discuss any of our comments with the Board or the FASB staff. Please direct your questions or comments to John Archambault, National Director of Professional Standards, at (312) 602-8701.

Very truly yours,



Grant Thornton LLP