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Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Proposal – Principles-Based Approach to U.S.
Standard Setting – No. 1125-001

Dear Sir,

The Fall 2002 graduate class on Contemporary Topics in Accounting at Baruch College is pleased to provide you with our comments on the FASB's proposal—Principles-Based Approach to U.S. Standards Setting. As we learn more about the contemporary topics of the day we have become much more aware of how complex it all is. There are so many rules to remember with exceptions to these rules and exceptions to the exceptions. Sometimes it seems frustrating as we attempt to memorize them while at the same time trying to keep the underlying concept in mind. And there are so many sources of accounting rules—the FASB, AcSEC, the EITF, and the SEC—that it seems overwhelming and it is no wonder that we keep reading about another restatement of earnings every day. We are pleased to see the FASB working on this topic and we hope it will make things better as we enter the profession.

On the other hand, we are somewhat skeptical regarding whether a principles-based approach can actually work in practice. It seems to us that there have to be some rules on how to carry out the principle and therefore it may be that a more realistic (and modest) goal is to have clearer principles and somewhat less detailed rules.

Our responses to the specific issues in the proposal are as follows:

1. Do we support the Board's proposal and will that approach improve the quality and transparency of U.S. financial accounting and reporting?

We agree with the Board's preliminary conclusion that an approach focusing more clearly on the principles in accounting standards is necessary to try to improve the quality and transparency of financial accounting and reporting in the U.S. One major benefit of this approach is that it could simplify accounting standards which could result in making it easier to comply with the principle rather than getting totally bogged down in trying to comply with a long list of detailed rules.

Over the past several months we have seen many newspaper articles critical of many of the U.S. accounting standards and suggesting that a principle-based approach is the way to possibly prevent more "Enron's." While it's not at all clear that these scandals arose because of bad accounting principles, it does seem clear that some companies tried to take advantage of the rules and report results that were not consistent with the economic substance of the transaction. Perhaps if preparers and auditors spent more time on substance and less on strict compliance with detailed rules, reporting would improve. Having principle-based standards and a sound conceptual framework for making decisions would go along way to improve the likelihood that substance over form will prevail.

Accordingly, we believe the Board should proceed and try to issue a standard that is principle-based, has few exceptions, and does not contain detailed rules for every possible scenario. Once the Board proposes such a standard as the "test-case," it will be interesting to see if respondents can avoid asking for more detailed guidance to comply with the principles. Even prior to that we imagine it will be difficult for the Board to agree on the right balance of principles and rules for this test-case as to some extent what makes a principles-based standard is in the eyes of the beholder.

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

Having an overall framework would make it easier to understand the accounting model. As we understand it, a true and fair view override means a company would not have to comply with a specific standard if in its facts and circumstances the results would be misleading and not reflect the substance of the transaction. This option is currently available to companies from the auditing rules and we believe it is appropriate for there to be an override rule in the authoritative accounting literature. However, there should be a strong presumption that following an FASB standard is what should be done. In virtually all cases it would seem inappropriate for a company to just decide it need not follow a standard based on its own subjective judgment. We believe an override should rarely be used.

3. Under what circumstances should interpretive and implementation guidance be provided and should the Board be the primary standard setter responsible for providing that guidance?

We believe all standards need at least some guidance on implementation. For example, the principle may be to recognize impairment of goodwill when appropriate but that of course wouldn't work. The principle has to be more explicit than that and it would probably be very difficult to even define what is a principle versus what is a rule. In all likelihood, once the FASB issues what it believes to be a principles-based standard (with some rules) covering say 80% (rather than almost 100%) of the issues, some practice problems are bound to arise as companies apply the new standard. Thus, there will be a need for some additional interpretative and implementation guidance to avoid having diversity on significant issues. However, there should be a greater tolerance for diversity in practice on less significant issues that will arise from time to time.

The Board should be the primary standard setter for providing additional guidance for the most significant matters when necessary. However, from a practical standpoint, since the FASB does not have the resources to do everything, the EITF should be used as well.

4. Will preparers, auditors, the SEC, investors, creditors, and other users be able to adjust to a principles-based approach? If not, what needs to be done and by whom?

If a principles-based approach is to be successful (in contrast to just using the name but still issuing 100 page plus complex standards, filled with many detailed rules), there will have to be a change in attitude. If going to a principles-based approach would only make it easier to inappropriately manage earnings, it will be a failure. If the SEC ends up continuously substituting its judgment over those made by preparers and auditors, it will be a failure. If plaintiffs continually sue companies through second-guessing their judgments, it will be a failure. For it to be successful, auditors must be willing to take stronger positions to just say no if they believe their client is not following the substance of the principal even if there is no rule saying the company literally can't do it.

For these groups to make the adjustment, the FASB would have to meet the challenge to be able to actually develop a standard that has clearly written principles that are understandable and have a well written basis of conclusions. The change to this model may have to be gradual with some period of experimentation and monitoring but it seems worthwhile for the FASB and others to give it a try.

5. What are the benefits and costs (including transition costs) and how might these benefits and costs be quantified?

Hopefully complying with accounting standards will become easier and financial reporting in reality as well as in perception (compared to today) will improve and the "Enron" chapter of financial reporting will finally end. As students approaching graduation, we hope this will be the case. On the other hand, one potential cost is that without enough guidance it could be hard to decide how to apply a principle and a lot of time will have to go into the decision process by companies throughout the country as they each go through a similar evaluation. In addition, there will be more diversity in practice—in some situations, different people will make different judgments on applying

a principle, even assuming good faith. We do not believe these benefits and costs could be quantified in any meaningful manner.

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?

We believe the Board should consider what criteria it itself would use to try to issue a principle-based standard. The judgments the Board will have to make on where to draw the line in writing the standard may be just as difficult as those judgments the preparers and auditors will have to make in complying with them. For example, some could view the interest capitalization draft principles-based standard included as an appendix in the proposal as still containing plenty of rules and it could have been much shorter and simpler.

If you or your staff have any questions on our response you can contact us through our professor, Norman Strauss (646 312 3174).

Sincerely,

See list below

Contemporary Accounting Topics Class
Baruch College

Contemporary Accounting Topics Class – ACC 9807
Baruch College
Fall 2002

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