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Comments on the Board's Proposal: Principles-Based Approach to U.S. Standard Setting.

The following comments are based on my experience as a lecturer (Prague University of Economics, www.vse.cz) teaching US GAAP and IAS (IFRS), and consultant (North Beach Holdings, Ltd., www.gaap-cz.com) assisting companies in applying these standards in the Czech Republic. I believe this experience has provided me with sufficient basis for these comments.

At the beginning of this letter, I would like to make one basic observation. To European professionals currently applying the various forms of "national GAAP" (such as Czech national standards, legislated standards based on the French system of accounting and compatible with EU directives on accounting), talk about whether US GAAP is "ules based" or IAS "principles based" is comparable to a debate between the owners of an Irish Setter and Labrador Retriever about which of their two pets is canine based. To the outside observer, both of these systems are "principles based." The only difference between them is that one is more specific and has more detailed guidance on how to apply the principles in practice than the other.

Also, if I may be so bold as to speak for the majority of my colleagues, the professional communities in countries such as ours, which are currently faced with the difficult task of trying to make a truly rules based, legislated accounting system yield meaningful information, are eagerly awaiting the day when we are allowed to use a principles based system regardless of whether that system is or will be like today's US GAAP or IAS.

Nevertheless, the Proposal does point to some difficulties in applying a "principles based" system like IAS in the United States. Since I am not in the position to judge how the US will be effected by this proposal, I will direct my comments at how such changes would effect US GAAP's "unrepresented" constituents, the companies and professionals applying these standards overseas. Also, since I am a member of the profession in a country that is merely a candidate to join the European Union, my comments are from the perspective of a professional who may not be able to influence the outcome of this debate, but who will, nonetheless, soon be directly effected by it.

The first issue facing a professional charged with applying a "principles based" system is that he or she must grasp and appreciate the logic of principles on which the system is based. For a professional not reared in the Anglo-Saxon, free-market tradition, this is a daunting task.

For example, such a professional may be able to learn that the principle of historical cost stipulates that non-financial assets should not be revalued to reflect a post acquisition increase in value. Since I spend a great deal of time tutoring such professionals in my country, I can safely say that most consider this principle to be illogical. The reason? Most, quite correctly, point to the fact that the historical cost of many assets (not only real estate and intangible assets such as internet addresses, technological standards or trademarks, but also industrial equipment used in industries such as glass or jewelry making that dates back a hundred or more years and would be prohibitively expensive to replace today) simply does not reflect their true value. Thus, if such a professional is to grasp the logic behind such a principle, a paradigm shift in his or her thinking is required.

First, such a professional must comprehend that it is not his or her role, as an accountant, to communicate an estimate, even an accurate estimate, about the value of some asset, but rather it is his or her responsibility to provide investors with the objectively verifiable facts (which, of necessity, must be historical) investors will use as a foundation for their own estimates. Second, and this is the hard part, the professional must reconcile the dilemma posed by such logic.

If taken to its logical conclusion, the historical cost principle implies that it is the investor's, and only the investor's, legitimate right to arbitrate the true value of corporate assets. Further, it implies that the investor engages in this exercise solely for the purpose of allocating his or her resources to where they will provide him or her with the highest return. Thus, in the aggregate, the principles that underlay US GAAP and IAS imply that only investors, not corporate managers, political leaders or religious authorities, bear the ultimate responsibility for allocating society's resources and that they do so on the basis of a single criteria: personal profit.

## Why does this pose a dilemma?

Because many professionals living in Europe have been taught that a person should be concerned with more than just his or her own personal profit and wellbeing. In many such countries, the Kantian / Hegelian philosophies that still dominate social and economic thought teach that focusing merely on profit is wrong. Accordingly, individuals have a greater responsibility than merely to themselves. They are responsible to their community, to the less fortunate, to their fellow man and to society as a whole. Thus, in a society where altruism and general welfare are valued more highly than individual profit, the principles that underlay US GAAP and IAS are, in fact, immoral.

Thus, if a "principles based" system such as IAS or US GAAP is to be successfully applied in countries such as Germany, France or Sweden, the local professionals, politicians and business leaders will have to be convinced that Adam Smith was right when he wrote: "By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good."

While the past 25 years in the United States (and past 10 or so in countries such as Finland and Ireland) have clearly given such free market ideas a boost, at the individual country level, this philosophical debate rages on. For example, in Germany, employees still receive representation on corporate boards even though they hold no ownership stake. In France and Italy, companies still refrain from closing loss making operations for fear of social unrest. In the U.K., the Blair government has been accused of backtracking on liberalization and squandering the Thatcher dividend. The same holds true at the individual citizen level. In most European countries, while there are those who endorse economic liberalization, most attempts at it are still met nationwide work stoppages, violent street protests and Keynesian-style rhetoric.

Thus, since many of the professionals who will be soon asked to implement a "principles based" system do not belong to the same school of thought as its drafters, the implications are clear. In the absence of reeducation on a massive scale, the only way a "principles based" system can be made to yield the desired result is to prescribe exactly how such a system shall be applied to day-in, day-out practice. To think otherwise, is naive.

But, even if all the philosophical difficulties are resolved, professionals who have spent their entire careers applying Europe's legalistic accounting systems will still be confronted with an undertaking of gargantuan proportions. In conversation, I have heard it compared to the job facing a bicycle repair mechanic who is thrown into a room full of car parts, shown a picture of a finished automobile and told to put one together. Herein lies the greatest challenge presented by a "principles based" system. It comes without instructions.

US GAAP is not like that. The individual standards, interpretations and implementation guides generally contain enough, sufficiently detailed guidance to allow anyone (assuming they can comprehend written English) to understand what is required based on what is written. In practice, this difference becomes immediately apparent. While the accountant trying to apply IAS to some particular issue is still trying to figure out what some generally worded paragraph really means, his or her colleague, using US GAAP, is done and off to the next issue.

A similar problem confronts educators. Not long after I first started teaching IAS, I got into a conversation with a colleague (who worked on the translation of IAS into Czech) about IAS 18 (revenue). She told me that IAS 18 was unintelligible and that, even after reading it 20 times, she still did not know what it was trying to tell her. I told her that when I read this standard, I found it understandable, concise and to the point. Her reply was "naturally, you already knew US GAAP when you read it. Now, try putting yourself into the shoes of someone who only knows Czech accounting."

This lack of specificity inherent to a "principles based" system often also has another significant consequence. While the preparer applying today's US GAAP is, more or less, independent and can proceed based on what is written, the preparer applying today's IAS must often rely on experts to translate the general principles into practical, step-by-step instructions. Since these experts do not work for free, the cost of applying IAS can be significantly higher than the cost of applying US GAAP. In my country, this point is not lost on preparers who prefer US GAAP primarily because it works right out of the box. Thus, rightly or wrongly, many of these individuals view the impending transition to "principles based" IFRS as a backhand attempt to transfer wealth from their company's coffers into the pockets of the professionals who helped draft the system.

**Note:** since my company provides IAS/US GAAP compliance services, I am one of those who stand to benefit from Europe's transition to IFRS.

Also note: since Czech society is not litigious (or, more specifically, since its legal system, like most of continental Europe's, is based on Napoleonic code and thus not conducive to large civil damage awards) and since Europe's securities regulation is fragmented with individual regulators being (at least in comparison to the SEC) relatively powerless, the question of being second-guessed by plaintiff's lawyers or securities regulators does not (yet) weigh heavy on the minds of Czech preparers whose primary concern is passing muster with tax authorities.

The other side of the coin is that US GAAP's detail and specificity lead some to complain of "standards overload." In all honesty, I have never heard this complaint from a client, but I hear it constantly from my colleagues in both education and business. This leads me to the conclusion that, while the complexity of US GAAP is a non-issue for preparers (who are generally able to focus on the few key issues and who welcome detailed and exact standards), it is the bane of professional educators and advice givers (who are expected to know everything).

Last spring, at a conference in Copenhagen, I got into a conversation with a colleague from the US. When I told him that I teach US GAAP and IAS, he asked me if I thought I understood US GAAP. I told him that I thought I did and all he could do was laugh. At first, I assumed it was because the name on my nametag was Mládek, but soon he confessed that, although he teaches accounting, he cannot make heads or tails of some standards and is so overwhelmed by their complexity that he doesn't feel comfortable discussing them at all. I told him that I do not have this problem because, when I need to get a grip on the forest, I take a look at IAS and then, when I need to dissect some individual tree, I turn to US GAAP.

Recently Samuel A. DiPiazza Jr. talked about a three-tier system (PricewaterhouseCoopers' CEO Seeks Global GAAP, By Lara Wozniak, The Wall Street Journal Online, December 18) and said: "The first tier is reporting according to global accounting standards -- not United States GAAP [generally accepted accounting principles] -- that are more principles-based and less rules-based. This will allow investors to compare any company with any other around the world. At the second tier of reporting, we propose industry-specific standards, created by each industry group, so that an investor can easily compare companies within the same industry. Finally, the third tier of reporting would be around company-specific information, such as management's view of the competitive environment, corporate strategies, compensation policies, etc."

In my view, such a system already exists. One only needs to combine current IAS, US GAAP and SEC requirements to get it.

This leads me to a suggestion: stop trying to make US GAAP like IAS and vice versa. Simply allow preparers to apply both.

Obviously, there are some caveats associated with this suggestion.

First, the FASB and IASB need to eliminate the obvious inconsistencies. Since most of these changes (for example, to procedures governing goodwill and foreign currency translations or

the elimination of many allowed alternatives) are already in the works, this issue has, more or less, already been addressed.

Second, the FASB and IASB should stick to their knitting. The IASB is very good at grasping the big picture. Also, with its 14 members, the big picture is probably maximum on which a majority will ever be able to agree. In contrast, the FASB is very good at applying general principles to specific accounting issues and, with the recent change in the law and its voting structure, should now be able to promulgate new standards in a much more timely fashion and with considerably fewer compromises.

Third, Sarbanes-Oxley will have to work as intended. If auditors (and by this I specifically mean the big four as they were before Enron) continue to treat their international operations as vacation getaways for tired, worn out US partners, no foreign company will ever take an auditor's visit seriously and allowing US companies to use IAS will only motivate them to go venue shopping for the country were the local big four office is especially lax.

Fourth, the reforms currently being undertaken by the European Commission will have to address the lack of compliance, not only with IAS but also with US GAAP (as discussed in studies such as Glaum and Street, 2002 and David Cairns, 2001), evident at European companies claiming to use one or the other.

Finally, preparers will have to be motivated to stay within the bounds of both systems even after they have a choice between the two.

While this last point may prove to be the trickiest, I believe (once the issues of inconsistency and lack of compliance have been resolved) it can be achieved in a minimally invasive way. The proposed revision to IAS 8 directs users to "In the absence of a particular Standard or an Interpretation of a Standard that specifically applies to an item in the financial statements... [use] ...pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards..." Since even current IAS already allows preparers to reference US GAAP, all that would be needed for them to reference US GAAP first would be for the SEC to issue a rule to that effect. The fact is, since US capital markets are, and long will be, the eight hundred pound gorilla of world finance, the SEC has tremendous power overseas, not only over companies that have issued securities in the US, but also over those contemplating such a move (which pretty much includes every company with international ambitions).

The benefit of such a solution would be that it would allow the preparers who will soon be obligated to use IFRS to approach the problem the same way preparers currently approach IAS: use US GAAP as learning tool and implementation guide. Also, since it would give those preparers wishing to use a "principles based" system the option of doing so, the pressure to turn US GAAP into such a system would subside.

In sum, I believe that, once the above are addressed, both IFRS and US GAAP should be recognized by the SEC as GAAP (as the term is defined in SEC. 108. of the Sarbanes-Oxley Act). I also believe that the primary benefit of such a solution would be to give the professionals, who find the 800 pages on derivatives overkill, something simpler and less intimidating to reference while it would leave the professionals like myself, who lack the mental acuity to ever grasp the nature of a derivative well enough to account for it correctly without 800 pages of guidance, something specific and detailed to fall back on.

Obviously, there are other alternatives: turning tomorrow's IFRS into US GAAP, turning today's US GAAP into IAS and finding a middle ground. The remainder of this comment letter is directed at these.

Contrary to what I implied in the first half of this letter, of the three alternatives, the first is (in the European context) the least inviting. The reason is that preparers in most of the European countries slated to adopt IFRS in 2005 already have a "rules based mindset" that makes the American version pale by comparison. In countries such as Germany, France and the Czech Republic, preparers are currently using accounting systems prescribed by law and spend much of their time seeking ways to apply legislated rules in a way that will minimize the tax burden. Such a mindset would segue very nicely into one aimed at applying a "rules based" financial accounting system in a way that would optimize reported financial performance. The only difference would be that by not following the spirit of specific accounting rules, these preparers would merely risk not passing muster with their local big four office, which presents a far lesser risk than not following the spirit of current European accounting law where, because financial and tax accounting are intertwined, the creative application of financial accounting rules can lead to criminal prosecution for tax evasion. With this threat gone, how a "rules based" would fare in Europe is an open question.

The second alternative is equally unappealing, but for the US. The reason is that Europe (especially continental Europe) is, more or less, like the US in a mirror. Where Europeans are risk averse, accustomed to following rules and disinclined to stand by their own judgment, Americans do not take well to rules, like to take chances and are generally not afraid of forming their own judgment. These traits may make Americans exceedingly good businessmen, but they also make them businessmen who are inclined to push the envelope, not only in business but also in accounting. As the old saw goes: in German, if is not allowed, it is forbidden while, in the US, if it is not forbidden, it is allowed. The implication is that, on this side of the Atlantic, managers have to be forced to exercise their judgment while the opposite is true in the US. Thus, Frits Bolkestein was correct in pointing out "If you look at the various scandals in the financial field, it seems to me they have occurred more in the US, or am I being rude saying that?" But he was right for the wrong reason. There have been no European Enrons not because a "principles based" approach is superior to a "rule based" one (after all, less than 300 companies currently use IAS), but because most European companies have been using national accounting standards that are based in law and have absolutely nothing to do with principles.

Note: in fairness to Mr. Bolkestein, it is important to add that since February 2002 (when that quote appeared in the Financial Times) he has changed his tone and was later quoted by the Wall Street Journal to say "Only the very foolish would pretend that recent events in America could not or will not happen here. The issues raised by Enron, WorldCom, Xerox and others are issues for us all, and issues that we must address urgently."

Thus, since I realize that I am in no position to lecture America on whether to implement a "principles based" accounting system or not, I will merely quote J. Edward Ketz who wrote: "The conclusion appears obvious. Those intent on pursuing the principles-based approach actually long for less reform and more accounting shenanigans. May the courts help us!" (http://accounting.smartpros.com/x36098.xml).

Finally, the third alternative. I believe that if tomorrow's "principles based" IFRS were accepted by the SEC as GAAP (once the issues raised earlier are resolved), this would be the long-term result. In short, given the choice, most preparers would welcome abiding by both systems at the same time. The practical consequence would be that the end result, the financial report prepared according to IFRS or US GAAP, would be indistinguishable, while neither system would need to sacrifice its unique character.

In conclusion, I believe that context should be the overriding factor in the "principles" versus "rules" debate. American society, with its litigious citizens, activist securities regulator and risk-seeking managers, is not an environment conducive to "principles based" accounting (regardless of how well Sarbanes-Oxley works at getting auditors to take their profession seriously again). European society, with its legally passive citizens, fragmented securities regulation and risk-averse managers, is not an environment conducive to "rules based" accounting (regardless how far the European Commission can push economic liberalization). Both regions would, however, benefit if preparers and users alike were able to exploit the advantages each system offers.

Note: in the past, I have argued against the SEC's allowing companies to choose between US GAAP and IAS (http://www.sec.gov/rules/concept/s70400/mladek1.txt). Events that have occurred since then (primarily the restructuring of the IASC, the creation of the IASB, the endorsement of IAS by EFRAG "en bloc" and decision of the FASB and IASB to work on convergence) have led me to change that position.