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Robert H. Herz
Chair
Financial Accounting Standards Board
File Reference 1125-001

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Dear Mr. Herz:

Re.: Comments on the "Proposal: Principles-Based Approach to U.S. Standard Setting"

The Institut der Wirtschaftsprüfer (IDW), which represents the German Wirtschaftsprüfer profession (German public auditors), would like to thank the Financial Accounting Standards Board for the opportunity to comment on the "Proposal: Principles-Based Approach to U.S. Standard Setting".

We have chosen to comment on this particular Proposal because we believe that the results of the deliberations on the issues identified will have a major impact on the nature and structure of accounting standards not only in the U.S., but also on a world-wide basis. This is particularly the case given the recent agreement on the commencement of the joint FASB-IASB convergence project. Furthermore, a significant portion of our membership is involved in auditing, reviewing or preparing US GAAP financial statements – either for business enterprises listed on securities exchanges, including those subject to registration with the SEC, or for German subsidiaries of U.S. business enterprises – and will therefore be directly affected by any changes in U.S. GAAP engendered by this Proposal.

General Comments

Before answering the individual questions posed by the Board, we would like to state that we support a principles-based approach to U.S. standard setting in general – not just for accounting standards. However, the term “principles-based” may mean different things to different parties. Consequently, prior to addressing the issues raised by the Board in those questions, we believe that we should provide you with our views in detail on what the term “principles-based standards” signifies for accounting standard setting from our perspective.

Principles-Based Standards Setting Process

In our view, principles-based standards imply the application of a principles-based standard setting process. This means that a systematic approach is taken when addressing accounting issues such that individual accounting issues are not dealt with in isolation, but are addressed as part of a consistently applied conceptual approach that represents a systematic whole. A systematic approach to standard setting presupposes the development of an internally consistent framework that addresses user needs and the behavioural effects of accounting information, the relationship between economic phenomena and accounting concepts, and the nature of accounting processes. Such a framework would form the foundation for accounting concepts used in the development of general principles. While the Statements of Financial Accounting Concepts represented groundbreaking developments when issued and remain documents of exceptional conceptual depth, the ongoing discussion shows that these Statements lack the coverage and depth necessary to represent an adequate framework for standard setting purposes.

In our view, a principles-based standard setting approach also implies that the accounting principles identified in the accounting standards are derived in a consistent fashion from the underlying framework – primarily by means of deductive reasoning. Furthermore, the framework should provide for the development of accounting principles so that the information presented in the financial statements does not vary materially from that used or which ought to be used by management to make business decisions. Hence, ideally the principles contained in accounting standards should be written so that managers tend to make business decisions based upon their economic merit rather than their effect on an accounting treatment. This means that, except for economic consequences directly tied to accounting treatment, the principles would be behaviourally neutral.

Of particular importance to a principles-based approach to standard setting is ensuring that accounting principles developed by the standard setting process are consistent with the underlying framework and with one another and create a systematic whole. This implies that major accounting issues currently only covered by general

practice or accounting textbooks or literature are addressed by projects in a systematic manner. Furthermore, it also means that additional projects that deal with pressing issues, and their results are seamlessly incorporated into and are consistent with the underlying framework and the overall structure of existing principles.

In rare circumstances, when practical considerations force departures from the underlying conceptual framework, these departures should be explicitly identified as practical considerations that do not impact upon the validity of the underlying framework.

Codification and Structure

However, the purpose of a principles-based standard setting process leading to an internally consistent framework and principles as described above would be defeated if such a structure were not presented in a logical form that assists interpretative activities and is easy to use. In our view, only an appropriate codification of accounting concepts and principles, in which the more important concepts and principles are emphasized compared to those less important, would assist interpretative activities and ease the application of these principles in practice. Examples of codification structures do exist in the U.S.¹ and suggestions to this effect have been made in the U.S. previously². Examples from outside the U.S. include the CICA Handbook – Accounting, the Third Book of the German Commercial Code dealing with accounting, and, with respect to accounting concepts, the IAS conceptual framework. The codification of accounting standards also implies that such a codification structure provide a “legislative history” of such standards, much like the legislative histories at the end of particular sections of the Codification of Federal Laws in the U.S.

The use of such a codification structure would not only assist interpretative activities and ease the application of principles, but would also support principles-based standard setting by allowing the standard setter to better determine the consistency of newly developed principles with existing principles and the relative rank and position of these new principles in comparison with those existing principles. Such a structure would include a codification of the conceptual framework and an umbrella standard (e.g. something similar to IAS 1) that contains fundamental principles as opposed to principles that deal with certain areas of accounting. Examples of fundamental princi-

¹ For example, the Codification of Federal Laws or the Codification of Federal Regulations, the Table of Contents of the Technical Questions and Answers in the AICPA Technical Practice Aids for accounting, the Codification of the Statements of Auditing Standards, and, to a lesser extent, the FASB Current Text

² Dennis R. Beresford, "It's Time to Simplify Accounting Standards", (AICPA: Journal of Accountancy, March 1999), pp. 65-67.

ples might be the maxim "economic substance over legal form" and the concept of "fair presentation".

Furthermore, a codification should not only include a definition of the hierarchy of pronouncements, but also the principles with which accounting standards are to be interpreted and the principles to be applied in developing the accounting treatment for specific issues where no specific standard or other authoritative guidance has yet been issued.

Authoritative Guidance and Additional Interpretative and Implementation Guidance

For the purposes of this discussion, we would like to distinguish between authoritative guidance and additional interpretative or implementation guidance. Authoritative guidance ought to reflect the views of the standard setter on the meaning and application of the principles expressed in the standards for different classes of transactions and circumstances and should be subject to full due process in conjunction with or in addition to that for the principles, depending upon when this authoritative guidance is issued. Additional interpretative and implementation guidance, on the other hand, represents the views of duly constituted expert authorities under the auspices of the standard setter on the application and implementation of the principles and authoritative guidance in more specific circumstances or their views on the correct accounting treatment of classes of transactions or circumstances for which no specific standards or authoritative guidance have been issued by the standard setter. The expert authority would need to be under the auspices of the standard setter to ensure that the nonauthoritative interpretative and implementation guidance issued by that authority remains consistent with the principles and authoritative guidance promulgated by the standard setter. Because this kind of authority would deal with emerging or urgent issues in addition to interpretative or implementation guidance, the due process procedures must be kept to a minimum. Hence, in our view, pronouncements would be limited to three kinds: two authoritative levels promulgated directly by the standard setter and one nonauthoritative level issued by an expert authority under the auspices of the standard setter.

In our view, given the complexities of transactions and business circumstances today, it is apparent that a principles-based approach to standard-setting cannot mean that no authoritative guidance to apply these principles need to be issued. Furthermore, in many instances additional interpretative or implementation guidance may be necessary to help resolve difficult issues encountered in practice. The important issue in this respect is that the authoritative guidance and the additional interpretative or implementation guidance be consistent with the principles in the standards, unless

in rare circumstances there are explicitly identified practical reasons for departures from these principles.

Furthermore, if the principles are expressed in short, pithy statements, the authoritative guidance will serve to explain the meaning of these statements in more detail for general problems. In this respect, we were particularly disappointed that the IASB chose to eliminate black lettering, since the use of black lettering to denote principles forces the standard setter to think first in terms of the general principle involved before addressing any authoritative guidance thereto. On the other hand, the additional interpretative or implementation guidance would serve not only to assist in the interpretation or implementation of existing principles and authoritative guidance for accounting issues covered by these, but would also address accounting issues not covered by specific principles or authoritative guidance other than those in the conceptual framework or the umbrella standard.

However, given a hierarchy of principles, this does not mean that, in the interpretation of accounting principles or authoritative guidance through the additional interpretative or implementation guidance or through practitioners, such accounting standards and authoritative guidance would be subject to a strict legalistic interpretation of their contents, such as by strict adherence to a legal subsumption process. This means that the principles contained in accounting standards and the authoritative guidance thereto should be subject to commercial or economic rather than legal interpretation because legalistic interpretation processes would inevitably lead to the violation of the fundamental principles (substance over form, fair presentation, etc.) of the system by those seeking to subvert the transparency of financial reporting in specific circumstances.

Furthermore, when issuing authoritative guidance or additional interpretative or implementation guidance, the guidance ought to be directly associated with a particular principle or group of principles by publishing that guidance directly adjacent to those principles or authoritative guidance being interpreted so that the meaning of the principles becomes more apparent when reading these. The issuance of guidance—whether authoritative or interpretative—in this form would also help ensure that the guidance is clearly derived from the principal addressed and would help in the identification of gaps where guidance is still needed. We should mention that in Germany our experiences have been primarily positive with guidance using a structure where the guidance is placed directly adjacent to the principles being interpreted (e.g., as commentaries to the accounting principles enshrined in the German Commercial Code).

Nevertheless, it should be recognized that neither the authoritative guidance nor the additional interpretative or implementation guidance should descend into detailed

rule-setting for individually identified cases – that is, the authoritative guidance may address classes of transactions or events and the additional interpretative or implementation guidance may deal with more detailed problems of general application, but neither should attempt to move beyond this to detailed rules that deal with every problem encountered by preparers and auditors. This implies that considerable room must be left for professional judgement. Consequently, it should be recognized that there may be more than just one reasonable solution to an accounting problem in a particular case. In this respect it is important that the financial statements disclose the effects of the accounting treatment chosen using that professional judgement. Furthermore, the application of professional judgement presupposes that such judgement will be applied in an objective manner and with integrity by preparers and auditors and that their mission in this respect is the fair presentation of the economic substance of transactions and events rather than the circumvention of principles.

Answers to the Specific Questions Posed by the Board

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 noted in the general comments, we support the Board's proposal for a principles-based approach to U.S. standard setting. However, this is predicated upon reaching a common understanding of what "principles-based standard setting" means in terms of process, codification and structure, and the role and structure of interpretation and additional guidance. We are convinced that such an approach will improve the quality and transparency of U.S. financial accounting and reporting because it will lead to a more transparent system of accounting standards in the U.S.

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?*

As noted in the general comments, the application of a principles-based standards setting system is predicated upon the development of an internally consistent conceptual framework defining fundamental financial accounting concepts and the issuance of a general standard or standards such as IAS 1 to ensure that those basic areas of accounting currently covered by practice, textbooks or other accounting literature are codified in some form. In this kind of structure, there will

naturally be a hierarchy of accounting principles – that is, some will be regarded as more important than others – and we provided some examples in our general comments of the kinds of general principles that might be included (economic substance over legal form, fair presentation).

In this context, the question of the acceptability of an override depends upon how an "override" is defined and what is being overridden. If, for example, financial statements contained departures from nonauthoritative additional interpretative or implementation guidance in those circumstances where that guidance is clearly not appropriate and this departure can be justified, then one may argue that neither the authoritative guidance nor the principles have been overridden and that such departures do not constitute an override. However, it is conceivable that authoritative guidance might be overridden in rare circumstances where the literal application of such guidance would lead to financial statements that are clearly misleading (i.e., not fairly presented) because that application would violate the principles contained in the standards.

Consequently, we would disagree with a provision allowing an override of the basic principles, or even worse, of the conceptual framework, that define what fair presentation in essence means because it would be difficult to make an objective determination as to whether the application of particular principles within a particular standard would no longer lead to fair presentation without a frame of reference. In our view, if, in extremely rare circumstances, compliance with a principle embodied in a standard appears to result in misleading financial statements, a departure from that principle should not be permitted. Rather, additional disclosures containing the reasons why a certain treatment required by a principle appears to result in misleading financial statements should be provided. Those disclosures should also include a detailed description of the financial impact of that treatment on the financial statements.

3. *Under what circumstances should interpretative 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?*

As noted in our general comments, we would like to distinguish between authoritative guidance that is subject to full due process and is promulgated by the standard setter in conjunction with or in addition to the principles, and additional interpretative or implementation guidance not subject to a laborious due process issued by duly constituted expert authorities under the auspices of the standard setter. In our view, authoritative guidance should be promulgated by the standard setter for all principles issued in conjunction with the issuance of those principles,

but additional authoritative guidance thereto may be issued thereafter if needed. The authoritative guidance should not, however, include detailed rules on the application of the principles in specific cases.

On the other hand, additional interpretative or implementation guidance should be issued by the expert authority for urgent or emerging accounting issues – both for those issues where this guidance would just interpret existing principles and authoritative guidance and for those issues where the interpretative or implementation guidance addresses issues not yet covered by specific principles or authoritative guidance beyond those or that in the conceptual framework or the umbrella standard. Unlike the authoritative guidance issued by the standard setter, the guidance issued by the expert authority would deal with the accounting treatment of more specific circumstances encountered in practice.

Furthermore, the expert authority should also issue interpretative or implementation guidance on a systematic basis to provide proper coverage of practical issues associated with the interpretation and implementation of the principles and their associated authoritative guidance. In this way, guidance may be issued for issues that will arise before they become urgent in practice. As mentioned previously in our comments, any additional interpretative or implementation guidance must be consistent with the conceptual framework, principles and authoritative guidance promulgated by the standard setter.

An important issue in relation to guidance is the role of the SEC. In our view, while the SEC should make its views on the accounting treatment of certain transactions or circumstances known to both the standard setter and the expert authority, we believe that the SEC should refrain from actually setting standards or issuing guidance. This also implies that enforcement actions for violations of accounting principles should be based on these principles and any guidance thereto rather than on the views of the SEC on the application of the principles.

4. *Will preparers, auditors and 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?*

In our view, preparers and auditors can adjust to a principles-based approach. However, because the principles and guidance would not constitute "detailed rules", both preparers and auditors will need to exercise greater professional judgement in the application of these principles and guidance. This is predicated upon a higher level of education and training for both preparers and auditors. Furthermore, the greater application of professional judgement rather than just

the search for a specific rule that applies in the circumstances may require a change in "mindset".

We believe that investors and creditors can also adjust to a principles-based approach, but that like preparers and auditors, they may require some additional education and training and a change in the mindset of investors and creditors.

We surmise that the SEC will bear a greater adjustment burden. The SEC, as mentioned before, will need to refrain from rule-making in accounting. Furthermore, the SEC will need to judge the reasonableness of arguments in relation to the principles and related guidance rather than rely on specific rules. Like for the other parties involved, this may mean that some additional education and training of SEC staff may be required. Furthermore, the SEC would have to recognize that in some circumstances there may not be a "right" answer, but should ensure that users are provided with the information needed to understand the effects of the accounting treatment chosen.

Principles-based standard setting, in which basic principles such as economic substance over legal form achieve primacy over a legalistic interpretation of rules suggests that many members of the legal profession currently involved in accounting issues may have the greatest difficulty in adjusting to the new accounting regime. It probably means that many of these members of the legal profession will need to obtain a greater knowledge of business administration, and in particular, of finance, microeconomics and management accounting. Furthermore, the legal basis for liability in a principles-based financial reporting framework would be much more difficult to determine, since such a system lacks specific rules to determine the accounting treatment of specific circumstances using legal subsumption. On the other hand, the application of general principles is not unknown in common law, and so there is no reason to believe that the legal profession is not in a position to surmount such a change in accounting regime.

5. *What are the benefits and costs (including transition costs) of adopting a principles-based approach to U.S. standards setting? How might those benefits and costs be quantified?*

We expect the costs of transition to be high – particularly in relation to education and the cost of the effort needed to place an entire accounting system on new foundations. However, we believe that the mid and long term benefits will significantly exceed the costs, since a principles-based approach as depicted in our general comments would greatly alleviate the standards overload problem and therefore lead to a more sustainable accounting framework. Furthermore, a prin-

ciples-based approach will – in our view – lead to more transparent financial reporting, since the basic principles (economic substance over legal form, fair presentation, etc.) are not designed to be circumvented: it is harder to circumvent a principle than a detailed rule. Ultimately, more transparent financial reporting should lead to less misallocation of capital in the economy, which ought to be associated with significant benefits. We also believe that a codification of US GAAP would lead to greater world-wide acceptance and would accelerate the convergence process with the IASB.

We believe that it would be very difficult to attempt to properly quantify those costs and benefits.

6. *What other factors should the Board consider in assessing the extent to which it should adapt a principles-based approach to U.S. standard setting?*

A principles-based approach may also require an adjustment to the litigation environment, for under a principles-based approach there may be more than one reasonable answer to a given problem, i.e., there may not be a “right” answer that would relieve a preparer or auditor of the risk of legal liability. Consequently, a fundamental discussion on the basis for legal liability under a principles-based approach to accounting may be necessary.

If you have any questions please do not hesitate to contact us.

Yours sincerely

Klaus-Peter Naumann
Chief Executive Officer

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