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Ms. Linda MacDonald  
Financial Accounting Standards Board  
401 Merritt 7, P.O. Box 5116  
Norwalk, CT 06856-5116

**Re: Proposal for a Principles-Based Approach to U.S. Standard Setting**  
**File Reference No. 1125-001**

Dear Ms. MacDonald:

We appreciate the opportunity to provide our preliminary comments on the Proposal for a Principles-Based Approach to U.S. Standard Setting (the Proposal). We commend the Board for its willingness to critically review its approach to standard setting, and are supportive of its efforts to improve the standard setting process.

In general, we believe that a move towards more principles-based standards would be a positive one. In recent years an increasing number of standards have been issued that, although they may have been originally grounded in basic principles, have since been subject to such a degree of authoritative interpretation that they have devolved into a series of detailed and highly complex rules. This process may have developed as auditors and preparers sought to ensure that standards were being applied consistently to complex transactions. However, the constant introduction of new rules and interpretations has created a "vicious cycle" whereby certain standards have become so specific that it is difficult for preparers to analyze new transactions based on intuition and logic, thus requiring the issuance of even more rules and interpretations. In some cases this has even led to guidance which is internally inconsistent. In any event, in many areas accounting has become much more complicated and has resulted in financial statements that are increasingly difficult to explain to the average investor.

We therefore applaud the Board for considering this new direction in standard-setting, as we believe it will enable preparers to take a substance-based approach when analyzing transactions, and will therefore ultimately provide greater clarity and transparency in the financial statements. Further, we believe that this approach is likely to enhance consistency rather than result in increased differences among entities because preparers will be required to account for

transactions based on an analysis of the underlying substance. As such, similar transactions with small technical differences will be accounted for in the same way.

That said, we think it important to clarify what we envision when the Board refers to a principles-based approach. We believe that this approach should be consistent with that taken in Statements 141 and 142, which we believe to be well-constructed standards that provide good evidence of principles-based guidance. As another example, in applying this approach to a project such as the FASB's Fair Value project, we would expect the Board to propose that all financial instruments be recorded at fair value; provide a definition of fair value (*e.g.*, exit price, with some additional elaboration); establish the scope of the instruments included (*e.g.*, define financial instruments and exclude an entity's stockholders' equity accounts); and provide very high-level guidance defining fair value. We would not expect to see prescriptive guidance on the calculation of fair value; rather, we believe this determination would be left to industry practice.

In this context, we respectfully offer some preliminary suggestions for implementing the FASB's proposal. We believe that the Board should proceed gradually, focusing its efforts first on new standards and then on those existing standards that are considered to be rules-based. We also believe that there will continue to be a need for both specialized industry guidance that is currently provided by the AICPA via its Industry Guides, as well as topic related guidance that is promulgated by an authoritative body such as the EITF, and we therefore would encourage the Board to consider maintaining these aspects of the standard-setting framework in some manner.

#### **Approach to modifying GAAP**

First, we agree that in order to have a principles-based approach, a clear and consistent conceptual framework is necessary. In this regard, we believe that the Concepts Statements provide a strong foundational framework. Rather than replace this foundation in its entirety, we believe it would be more practical and efficient to modify the framework where it is either internally inconsistent or where improvements are deemed necessary.

In addition, we do not believe that the Concepts Statements should be amended before the principles-based approach is applied to individual standards. We have found that it is extremely difficult for constituents to comment meaningfully on proposed amendments to Concepts Statements in the abstract without an understanding of the practical implications of the proposed changes. Therefore, we would recommend that the Board amend the Concepts Statements in tandem with amendments to new standards. This is similar to how the Board proceeded in its project on Liabilities and Equity, where a proposed *Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities* was released in conjunction with a proposal on *Accounting for Financial Instruments with Characteristics of Liabilities, Equities, or Both*. Without debating the merits of the proposals themselves, we believe that

this type of coordinated approach enables constituents to clearly understand the implications of a proposed amendment to the Concepts Statements.

With respect to the application of a principles-based approach to accounting standards, we do not believe that the Board should undertake a project to systematically rewrite all existing US GAAP. We believe that many standards are already fundamentally principles-based (for example, Statement No. 5 and Statement No. 115), and therefore do not need extensive modification. We believe a complete overhaul would be overly time-consuming and would therefore unnecessarily delay progress in areas where significant change is required. Accordingly, we recommend that the FASB proceed gradually, by applying the new approach first to new proposals that are currently under consideration or in process. For example, a good place to start would be the FASB project on Revenue Recognition. We believe that proceeding in a more phased-in manner would be superior in that it would enable market participants to provide feedback to the FASB during the early stages of adoption as new principles are incorporated into the financial reporting system. This would also allow the Board to see potential flaws should a principles-based approach become oversimplified or too general in nature.

In addition to applying the approach to new proposals, we believe the Board should address existing standards and other guidance (e.g., EITF and AICPA guidance) where there is wide consensus that the decisions reached resulted in more of a rules-based than a principles-based standard. The most obvious example is, of course, Statement No. 133, where the myriad of rules and interpretations create an environment where only Statement 133 experts who have been following the standard from implementation can conclude on many issues. Other examples would include Statement No. 13, where “bright line” tests are used to distinguish between capital and operating leases; EITF Issue No. 00-19, where the principle that an instrument is equity if it can be settled in shares by the issuer is clouded by eight additional detailed criteria; and Statement No. 140, where the principle that assets should be derecognized when a transfer has relinquished control is transformed into a rules-based standard by the addition of a multitude of requirements that in many instances have little to do with the fundamental principle of control.

In our view, the combination of 1) applying a principles-based approach for new standards, 2) modifying the significant “offenders”, and 3) amending the Concepts Statements on an *ad hoc* basis to address inconsistencies with new and modified guidance, should lead to a unified principles-based body of standards for entities that report under US GAAP. This strategy, coupled with the advancement of the international convergence project, should also lead to harmonization with the international trend towards principles-based accounting standards.

#### **Need for Interpretive and Specialized Industry Guidance**

Although the proposal does not directly indicate that the Board intends to disband standard-setting bodies such as the EITF, it does suggest that different hierarchies in GAAP are inconsistent with a principles-based approach. We would not support disbanding these

standard-setters, and in fact, would be concerned with a significant reduction in their role. We believe that these groups provide a vital service through their ability to quickly issue guidance for new markets and industries. Further, other governing bodies that have adopted a principles-based approach to standard setting still maintain similar bodies. For example, the Urgent Issues Task Force in the United Kingdom and the International Financial Reporting Interpretations Committee under International Accounting Standards play similar roles to the EITF in establishing guidance. However, we do note that these bodies issue guidance far less frequently and focus on issues for which there is conflicting opinion.

Our main concern about a significantly reduced EITF role in standard setting is that a certain amount of interpretive and implementation guidance will be required to maintain a level of consistency in financial reporting. For instance, there may be questions about the appropriate guidance to analogize to when transactions fall between two or more statements. When standard setters provide this guidance, constituents have the opportunity to voice their ideas and highlight issues. And, in many instances, this process has improved the resulting guidance. Without an official body, interpretive guidance could be set by a small group of practitioners leaving many constituents without an avenue to express their points of view. Further, interpretations established in this manner are typically not published, which can leave preparers with the task of reporting based on "phantom" guidance. Interpretive bodies take the guesswork out of the process and provide all constituents with the ability to express their views. We would, of course, recommend that the EITF similarly adhere to the mandate of a principles-based approach to standard setting. Assuming this is accomplished, we believe that the EITF would be the most appropriate body to address narrow implementation practice issues and would encourage the FASB to maintain this arm of the standard-setting hierarchy, as we believe it has, on the whole, functioned successfully in the past.

We also believe that there remains a need for the type of specialized industry guidance that is currently provided by the AICPA Industry Guides. We believe that such guidance addresses significant practice needs for industries that apply a basis of accounting, which differs significantly from the historical cost model, such as the insurance industry and the financial services industry. We are indifferent as to which organization should provide such guidance, whether it be the AICPA, the FASB, or some other group; however we feel strongly that there is a need to maintain this body of guidance for complex and specialized industries.

#### **True and Fair View Override**

We are still considering the need for an overall reporting framework similar to that in IAS 1, *Presentation of Financial Statements*. We do, however, strongly support the concept of a "true and fair view override". Under a principles-based accounting framework, the use of a true and fair view override should be rare because the principles should properly capture the substance of transactions. However, we can envision instances when the substance of a transaction is not adequately captured by the established principle and believe there should be

an opportunity for a preparer to depart from the established principle if that were deemed necessary to present the financial statements in an economically faithful manner.

**Conclusion**

Overall, we support a principles-based approach to standard setting. We believe that if principles-based accounting is adopted on a gradual, phased-in basis, this will allow sufficient time for market participants to adjust to the new approach and provide useful feedback to FASB. We believe the benefits of such an approach would be a more flexible framework that would more easily be applied to newly developed products and transactions, and one that will allow constituents to analyze transactions based on their economic substance. We understand that making this type of directional change is no small challenge, and will take considerable thought and effort by both the Board as it develops a new approach, and by preparers and auditors as they adapt to the new environment. However, we believe that the potential benefits make this a worthwhile endeavor, and we would be happy to assist the Board in any way possible.

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We appreciate the opportunity to provide our preliminary comments on this important proposal. We look forward to joining the round table discussion and may provide additional comments based on further insight gained from our participation.

Sincerely,

*/s/ Esther Mills*

Esther Mills  
First Vice President  
Merrill Lynch