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United States General Accounting Office Washington, DC 20548

January 14, 2003

Director of Research Financial Accounting Standards Board File Reference No. 1125-001 401 Merritt 7 P.O.Box 5116 Norwalk, Connecticut 06856-5116

Dear Sir:

The U.S. General Accounting Office (GAO) has reviewed the FASB Proposal for a Principles-Based Approach to U.S. Standard Setting. We are pleased to provide our comments on this very important issue.

Financial accounting and reporting are critical components in our system for efficiently allocating capital among entities. Financial statements must be timely, relevant and reliable to be useful for decision-making purposes. The public's confidence in the reliability of issuers' financial statements underlies investment decisions and as we have recently seen, when impaired, can have a dramatic impact on financial markets.

Because of the recent turmoil in financial markets attributable, at least in part, to accounting and reporting problems, Congress has called upon GAO to study various topics. We have especially studied the recent increase in the number and size of financial restatements and disclosures of accounting issues and irregularities underlying these restatements. Significant questions have surfaced about the adequacy of the current system of corporate governance, investment banking practices, external auditing, governmental oversight, financial reporting, accounting principles and the standard-setting process.

We have concluded that current accounting guidance is overly rules-based and complex and is complicated by being promulgated by multiple standard setters. Thus, we strongly support FASB's proposed broad, principles-based approach to high-quality accounting standards that will serve the public interest, strengthen transparency and accountability and help to ensure the accuracy and integrity of the financial reporting system.

We believe that FASB's objective must be to develop accounting standards that emphasize broad principles derived from its conceptual framework; such standards will require the exercise of professional judgment by financial statement preparers and attestors. Application of any principles-based approach must focus on the

economic substance of transactions and financial statements on reporting economic activity as faithfully as possible.

Just as this approach will require greater judgment among prepares and attestors, it will also place burdens on regulators, especially the SEC, investors, creditors and other users of financial information who will be confronted with more divergence in the application of standards and diminished comparability in financial reports.

We recognize that the current environment is characterized by an increasing proclivity to litigate and by a tendency to seek out "safe harbors" that permit structuring of transactions in a manner to assure economic benefits while avoiding negative reported implications. We nonetheless believe that a transition to principles-based standards can be successfully achieved in a reasonable period of time and at reasonable cost. We further believe that those most responsible for making the transition are capable of the task and will ultimately be rewarded as the public confidence in our market system is restored.

The following are our responses to the specific questions posed in your Proposal:

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?

GAO strongly supports a principles-based approach to standard setting in the U.S. and internationally to improve the quality and transparency of financial accounting and reporting. Broad, principles-based standards derived from FASB's conceptual framework should be promulgated with provision for few exceptions in scope, application or transition. We recognize that the conceptual framework needs expansion, clarification and possibly some modification and anticipate that this can be accomplished. There will be some need for interpretive or implementation guidance; such guidance should be promulgated by FASB or specifically endorsed by FASB. That which is endorsed by FASB should be retrievable through a FASB data bank.

As you know, GAO is responsible for promulgating Government Auditing Standards that must be adhered to in all federal audits and in many other governmental audits. We are committed to issuing only principles-based standards from this time forward and are taking steps to revise existing standards to cause them to be principles-based. Our most recently issued revision dealing with auditor independence articulates two fundamental, overarching principles:

- A- Independent auditors must not perform management functions or make management decisions, and
- B- Independent auditors must not audit their own work or provide non-audit services in situations where the services involved or the products of the services are significant or material to the subject matter of the audit.

Because our intent is to prohibit conduct previously deemed acceptable, we did

issue additional interpretive guidance. This is in all instances consistent with the fundamental principles and it provides no exceptions to the principles; it does provide short term, transition guidance.

GAO also has a representative on the Federal Accounting Standards Advisory Board which promulgates GAAP for federal entities. Our representative is actively working to cause FASAB to promulgate only principles-based standards.

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?

The Board presently has in place a conceptual framework that guides its specific standards. As your proposal indicates, there are missing elements, inconsistencies and undefined elements in the framework. For those reasons, the framework needs attention and some rework. Nonetheless, it provides a substantial portion of a necessary conceptual framework.

We are supportive of the provision for a "true and fair override." We foresee that there may be certain instances where a choice might have to be made among differing treatments called for by different principles or where it is felt that adherence to a particular principle would result in reporting that is misleading or not representationally faithful to the substance of a transaction. In such instances, we believe it should be mandatory that the deviation from the specific, articulated principle be noted with an explanation for the reason for the deviation. We believe that in such an instance, while the specific principle is being disregarded, the overarching concept of true and faithful representation is being honored.

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?

There will be circumstances requiring some detailed guidance; we expect this to be more necessary in the early stages of the transition as preparers, attestors and users accustom themselves to this new approach and as the conceptual framework is modified and expanded. Further, there will be situations where the accounting called for by existing standards is modified; this could arise, for example, as exceptions to the application of a principle are eliminated or in connection with international convergence efforts. These situations might also call for expanded guidance. Generally, well-conceived standards should not need further guidance. We also believe that the Board should be the authoritative source of private-sector guidance, either as promulgator or by explicit endorsement.

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?

On December 9, 2002 we hosted our second forum on Corporate Governance, Transparency and Accountability; more than 30 members of the above groups participated, including FASB Chairman Herz. Based on their comments and, more importantly, their attitudes, we are confident that a successful transition can be

accomplished. While we believe that the transition will surface some difficulties, it is a necessary step in restoring confidence in the minds of those who use financial information.

We previously mentioned that some diversity in application of standards will be inevitable. All parties must be mindful of this and must be willing to accept thoughtful, good faith diversity. The understanding and judgments of all parties will be enhanced if disclosures regarding the application of standards are more detailed and reveal key assumptions, methodologies and rationales. Preparers and attestors will bear an especially heavy burden in that they are being asked to make best judgments based on the principle underlying the standard and on the specific fact pattern confronting them. Decisions of other auditors and preparers in similar situations may be useful, but should not be viewed as providing dispositive, precedental value.

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?

Dealing first with costs, transitioning to a principles-based set of standards will involve additional costs for all parties. After a reasonable transition period, we do not envision significantly increased costs in setting or in implementing the standards.

We are mindful of the concerns of many that this approach will increase the number of professional judgments required of preparers and attestors and that their judgments can be second guessed—particularly in court. We acknowledge that this is a problem which must be confronted.

Once again, we strongly believe that the transition to principles-based standards is a necessary part of efforts to restore confidence in financial information that is a fundamental underpinning of our market-based economy. We rate the benefit as very great—and the changed approach as a practical necessity.

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 Board should consider and formulate plans for the following:

- Completion of a comprehensive conceptual framework that will provide the foundation for accounting principles that can guide preparers and attestors without need for detailed application rules.
- 2. Revision of existing standards to make them principles-based.
- Development of a transition plan for going from rules-based to principles-based standards.
- Guidance relating to enhanced financial statement disclosures regarding the application of standards including their selection, related key assumptions, methodologies and rationales.
- Development of a retrievable data bank for accounting guidance materials promulgated or endorsed by the Board.
- 6. Publication of guidance to:

- Emphasize to preparers and attestors their responsibility for professional judgment based on the spirit of principles-based standards.
- Emphasize to users of financial statements, including lawyers and judges, that the abovementioned professional judgments will necessarily be characterized by some diversity in application of standards.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments with you at a convenient time.

Sincerely yours,

David M. Walker Comptroller General of the United States