Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System

Submitted to Committee on Banking, Housing, and Urban Affairs of the United States Senate and Committee on Financial Services of the United States House of Representatives

Office of the Chief Accountant
Office of Economic Analysis
United States Securities and Exchange Commission

This is a report prepared by the staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

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GLOSSARY OF ACRONYMS

AAA	American Accounting Association
AAER	Accounting and Auditing Enforcement Release
AcSEC	Accounting Standards Executive Committee of the American Institute of Certified Public Accountants
AIA	American Institute of Accountants
AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board
ARB	Accounting Research Bulletin
ASR	Accounting Series Release
AU	Codification of Auditing Standards

Commission	United States Securities and Exchange Commission
Committee	Committee on Accounting Procedure
DIG	Derivatives Implementation Group
EC	European Commission
EITF	Emerging Issues Task Force
FAF	Financial Accounting Foundation
FASB	Financial Accounting Standards Board
FEI	Financial Executives International
FSP	FASB Staff Position
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRS	International Financial Reporting Standard
IMA	Institute of Management Accountants
MD&A	Management's Discussion and Analysis
PCAOB	Public Company Accounting Oversight Board
SAB	Staff Accounting Bulletin
SAS	Statement on Auditing Standards
SEC	United States Securities and Exchange Commission
SFAC	Statement of Financial Accounting Concepts
SFAS	Statement of Financial Accounting Standards
SOP	Statement of Position

Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System

Executive Summary

The Sarbanes-Oxley Act of 2002 ("the Act") sought, among other things, to improve our system of financial reporting by reinforcing the checks and balances that are critical to investor confidence. Additionally, Congress recognized that questions remain regarding the approach by which accounting standards are established. As directed by the Act, we have conducted a study of the approach to standard setting and found that imperfections exist when standards are established on either a rules-based or a principles-only basis. Principles-only standards may present enforcement difficulties because they provide little guidance or structure for exercising professional judgment by preparers and auditors. Rules-based standards often provide a vehicle for circumventing the intention of the standard. As a result of our study, the staff recommends that those

involved in the standard-setting process more consistently develop standards on a principles-based or objectives-oriented basis. Such standards should have the following characteristics:

- Be based on an improved and consistently applied conceptual framework;
- Clearly state the accounting objective of the standard;
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis;[1]
- Minimize exceptions from the standard;
- Avoid use of percentage tests ("bright-lines") that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard.

The Act requires changes in many facets of the financial reporting by and analysis of companies. Some of the important changes being implemented and studies being undertaken under the direction of the Act are: (1) required certification of information by company CEOs and CFOs, (2) empowerment of audit committees to engage and approve the services provided by independent auditors, (3) more stringent auditor independence standards, (4) greater oversight of auditors through the establishment of the Public Company Accounting Oversight Board, (5) a study of whether investment banks played a role in the manipulation of earnings by some public companies, and (6) greater independence for the accounting standard setter. Additionally, as noted above, the Act directed the Securities and Exchange Commission ("SEC") to conduct a study on the adoption by the United States financial reporting system of a principles-based standard setting process and to submit a report thereon to Congress. This study is intended to fulfill that mandate.

In the staff's view, U.S. generally accepted accounting principles ("GAAP"), despite being the historical product of a mixture of standard setting approaches, constitutes the most complete and well developed set of accounting standards in the world. These standards vary significantly in their level of detail, adherence to a conceptual framework, and reliance on objectives and rules. While it has become fashionable recently to refer to principles-based and rules-based standards, these categories are not well defined and, therefore, are subject to a wide variety of interpretations. To conduct a study of the adoption of principles-based standard setting in the U.S., we first had to provide a clear definition of the optimal type of principles-based accounting standards and to distinguish it from other approaches.

We chose to base the study on what we considered to be the optimal type of principles-based accounting standards because we believe that Congress' intent was to have the staff consider whether a different standard-setting paradigm from the one that exists today would be beneficial to U.S. investors. We believe that neither U.S. GAAP nor international accounting standards, as currently comprised, are representative of the optimum type of principles-based standards. Defining what we believe to be the optimal

paradigm provides a necessary framework for this study.

In our minds, an optimal standard involves a concise statement of substantive accounting principle where the accounting objective has been included at an appropriate level of specificity as an integral part of the standard and where few, if any, exceptions or conceptual inconsistencies are included in the standard. Further, such a standard should provide an appropriate amount of implementation guidance given the nature of the class of transactions or events and should be devoid of bright-line tests. Finally, such a standard should be consistent with, and derive from, a coherent conceptual framework of financial reporting.

To distinguish this study's vision of the optimal approach from less formally defined approaches proposed by others, we refer to our approach as "objectives-oriented" standard setting. We do occasionally refer to principles-based standard setting in the study, by which we mean standard setting approaches that approximate the objectives-oriented approach we have defined. This study concludes that objectives-oriented standard setting is desirable and that, to the extent U.S. standard setters have not already done so, the benefit of adopting this approach in the U.S. should justify the costs.

In contrast to objectives-oriented standards (as we have defined the term), rules-based standards can provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of standards.[2] This can result in financial reporting that is not representationally faithful to the underlying economic substance of transactions and events. In a rules-based system, financial reporting may well come to be seen as an act of compliance rather than an act of communication. Additionally, because the multiple exceptions lead to internal inconsistencies, significant judgment is needed in determining where within the myriad of possible exceptions an accounting transaction falls.

At the other extreme, a principles-only approach (which some have suggested as the meaning of the term principles-based accounting standards) typically provides insufficient guidance to make the standards reliably operational. As a consequence, principles-only standards require preparers and auditors to exercise significant judgment in applying overly-broad standards to more specific transactions and events, and often do not provide a sufficient structure to frame the judgment that must be made.[3] The result of principles-only standards can be a significant loss of comparability among reporting entities. Furthermore, under a principles-only standard setting regime, the increased reliance on the capabilities and judgment of preparers and auditors could increase the likelihood of retrospective disagreements on accounting treatments. In turn, this could result in an increase for both companies and auditors in litigation with both regulators and the plaintiffs' bar.

In contrast to these extremes, objectives-oriented standards explicitly charge management with the responsibility for capturing within the company's financial reports the economic substance of transactions and events-not abstractly, but as defined specifically and framed by the substantive objectives built into each pertinent standard. In turn, auditors

would be held responsible for reporting whether management has fulfilled that responsibility. Accordingly, objectives-oriented standards place greater emphasis on the responsibility of both management and auditors to ensure that the financial reporting captures the objectives of the standard than do either rules-based standards or principles-only standards. Further, if properly constructed, we believe objectives-oriented standards may require less use of judgment than either rules-based or principles-only standards, and thus, may serve to better facilitate consistency and compliance with the intent of the standards.

Fundamental to this approach is that the objectives-oriented standards, as defined herein, would clearly establish the objectives and the accounting model for the class of transactions, providing management and auditors with a framework that is sufficiently detailed for the standards to be operational. At the same time, if constructed with the optimal level of detail, such standards would provide users, as well as regulators and others who oversee or monitor the financial reporting process, with sufficient detail to better comprehend and properly gauge the results reported by management and attested to by the auditors. Further, because objectives-oriented standards provide a better framework in which to exercise professional judgment than do either rules-based or principles-only standards, they may serve to better facilitate compliance with the intent of the standards.

In this manner, an objectives-oriented approach should provide the means by which management and auditors may be held accountable for reporting the substance of transactions within the financial statements. We believe that this responsibility-to ensure the fulfillment of specific, substantive accounting objectives-more effectively aligns the interests of management and auditors with those of investors, than do either a rules-based approach or a principles-only approach. As a consequence, we conclude that an objectives-oriented approach should ultimately result in more meaningful and informative financial statements.

In addition, and importantly, under an objectives-oriented system, the cost to investors and analysts of comprehending the standards themselves is expected to be lower. Indeed, ideally, an investor or analyst would obtain a reasoned conceptual understanding of the meaning of reported numbers by studying the stated objective of the pertinent standards. That is, under an objectives-oriented regime, each standard's stated objective assists the user in comprehending how the standard is constructed, how it is to be applied to a class of transactions or events, and how those transactions or events should be reflected in the company's financial statements.

Another benefit of objectives-oriented standards is that they may serve to enhance the quality, consistency, and timeliness of the standard setting process itself. With today's faster pace of change, timeliness in the development of accounting standards has become increasingly important. Under an objectives-oriented regime, standard setters should be able to move faster to address emerging practice issues while still providing sufficient guidance so that the standards are operational.

An additional benefit is the facilitation of greater convergence between U.S. GAAP and international standards. Standard setters can come to an agreement on a principle more rapidly than they can on a highly detailed

rule. The benefits of convergence include greater comparability and improved capital formation globally. We believe that neither current U.S. GAAP nor the current array of international standards strike an optimal balance in the various trade-offs inherent in standard setting, and thus we see convergence as a process of continuing discovery and opportunity to learn by both U.S. and international standard setters.

Other issues relevant to an economic analysis of an objectives-oriented approach are explored in the body of the study. These include: costs of accounting services, comparability issues, certain transition costs, and litigation uncertainty.

We believe, however, that the concern over litigation uncertainty is sometimes overstated and may arise out of a confusion between principles-based and principles-only standards. If preparers and auditors maintain contemporaneous documentation that demonstrates that they properly determined the substance of a covered transaction or event, applied the proper body of literature to it, had a sound basis for their conclusions-particularly those involving the exercise of judgment-and ensured through disclosure that their method was transparent, their exposure to litigation may be reduced.

While we conclude that the benefits of adopting objectives-oriented or principles-based standards in the U.S. justify the costs, the magnitude of these benefits and costs are extremely difficult to assess. Indeed, a study of the relative merits of adoption by the U.S. financial reporting system of principles-based accounting standards, as mandated by the Act, does not lend itself to a direct empirical test prior to its adoption and implementation. Moreover, the work of balancing the various trade-offs inherent in standard setting is an on-going process of discovery with many participants. Indeed, we would not expect these trade-offs to carry the same weights from one accounting issue to the next. In light of these challenges, the focus of our economic analysis has been to identify the most important trade-offs in setting accounting standards that relate to the application of principles versus rules. The study, while being directional and conceptual in nature, is informed through both economic analysis and accounting experience.

As such, this study is a policy study. In it, we will be characterizing certain existing U.S. GAAP standards and, at least implicitly, criticizing the manner in which some standards are currently structured and formulated. We do this to fulfill a legislative mandate. Nonetheless, nothing in this study should be construed as indicating a belief by the staff that any current U.S. GAAP standard is lacking in terms of providing sufficient structure, guidance, and consistency to hold preparers and auditors accountable and to be enforceable, as we do not believe that to be the case. Recognition that there is room for improvement to the standards should not be confused with a suggestion that current standards are inadequate. As noted above, we believe that the current U.S. standards are the most complete and well developed set of accounting standards in the world.

As we will demonstrate, U.S. standard setters have begun the shift to objectives-oriented standard setting and are doing so on a prospective, project-by-project basis. We expect that the U.S. standard setters will continue to move towards objectives-oriented standard setting on a

transitional or evolutionary basis. Operationalizing an objectives-oriented approach to standard setting in the U.S. requires the standard setters to undertake the following key steps, which are explored in more detail in this report:

- Ensure that newly-developed standards articulate the accounting objectives and are devoid of scope exceptions, bright-lines and excessive detail;
- When developing new standards, ensure that they are aligned with an improved conceptual framework;[4]
- Address current standards that are more rules-based;
- Address deficiencies in the conceptual framework;
- Redefine the GAAP hierarchy;[5] and
- Continue efforts on convergence.

The following table outlines the key steps required for the U.S. standard setting process to move to a more objectives-oriented approach.

Action Items	Current Status	Time Horizon
Conceptual framework improvements project	FASB currently evaluating most efficient approach[a]	Medium Term
Move towards objectives-oriented form of standards	Recent standards (e.g., SFAS No. 141 and following) have included elements of objectives-oriented form	Immediate
Comprehensive review of current standards to identify and address those that are rules-based	SFAS No. 141 superseded APB Opinion No. 16 (rules-based); accounting for stock-based compensation added to FASB agenda on March 12, 2003; staff and Board are evaluating existing standards for purposes of future agenda decisions	Underway
One standard setter[b]	AcSEC will no longer be responsible for issuing "authoritative" standards, transition plan is in place; EITF consensuses now are subject to FASB approval	Underway
Redefine GAAP hierarchy	Conceptual framework improvements project to be completed first	Medium term
Convergence	In October 2002, FASB and IASB jointly announced intention to work towards convergence of international and domestic standards. Joint or cooperative projects underway include business combinations, measuring financial performance, stock-based	Underway, some standards expected to be issued within the next year, but effort will be long term

	compensation, revenue recognition, and short-term convergence[c]	

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I. Introduction

A. The Mandate to Study Principles-Based Accounting Standards

The recent spate of major corporate accounting scandals suggested to many that our system of corporate governance and financial reporting is in need of improvement. To many it appears that, at least in some cases, the checks-and-balances within the financial reporting system-ranging from management to auditors, audit committees, boards of directors, analysts, rating agencies, corporate counsel, standard setters, regulators and the investors themselves-failed to prevent or detect large-scale fraud in major corporations which were carried out over extended periods of time. While we believe the financial reporting system remains fundamentally sound, and, generally, of the highest quality, these failures were a call for action.

Congress responded by passing the Sarbanes-Oxley Act of 2002 ("the Act"),[1] the most significant piece of securities legislation since the 1930s. Much of the Act may be viewed as a legislative attempt to better align the incentives of management, auditors and other professionals with those of investors. For example, with respect to corporate management, the Act increased penalties[2] for violations of securities laws and required certification of financial results by key corporate officers. With respect to auditors, the Act directed the Commission to establish rules prohibiting auditors from the provision of certain non-audit services to audit clients and rules to strengthen oversight of the audit process by audit committees. Additionally, it called for increased resources for inspection, review and enforcement with respect to auditors through the creation of the Public Company Accounting Oversight Board ("PCAOB").

In sum, the Act called for improvement in the checks-and-balances that govern the production of financial information provided to investors and, thereby, served notice on bad actors that they would be discovered and dealt with for their misrepresentations. But the logical question loomed as to whether these actions addressed completely the causes of these financial scandals. Many asked whether, beyond the bad actors, the accounting standards themselves might have played some role in facilitating or even encouraging the bad behavior. More generally, many asked whether technical compliance with U.S. accounting standards necessarily results in financial reporting that fairly reflects the underlying economic reality of reporting entities.

Among these concerns, there was a growing sense that the standard setting process in the U.S. may have become overly rules-based. Three of the more significant and commonly-accepted shortcomings of rules-based

standards are that they:

- Contain numerous bright-line tests, which ultimately can be misused by financial engineers as a roadmap to comply with the letter but not the spirit of standards;
- Contain numerous exceptions to the principles purportedly underlying the standards, resulting in inconsistencies in accounting treatment of transactions and events with similar economic substance, and;
- Further a need and demand for voluminously detailed implementation guidance on the application of the standard, creating complexity in and uncertainty about the application of the standard.

Accordingly, Section 108(d) of the Act calls upon the staff of the Securities and Exchange Commission ("Commission" or "SEC") to conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system and for the Commission to submit a report thereon to Congress by July 30, 2003.[3] The Act mandates that the study shall include: (i) the extent to which principles-based accounting and financial reporting exists in the United States;[4] (ii) the length of time required for change from a rules-based to a principles-based financial reporting system;[5] (iii) the feasibility of and proposed methods by which a principles-based system may be implemented;[6] and (iv) a thorough economic analysis of the implementation of a principles-based system.[7] This study responds to these mandated inquiries.

B. Participants in the Financial Reporting Process and the Reforms of Sarbanes-Oxley

The objectives of financial reporting are to provide information that is useful to investors and creditors[8] in their decision-making process.[9] In order for the financial reporting process to be successful-that is, for the objectives to be accomplished-many participants play important roles. Among the participants whose roles are critical to the success of the financial reporting process are company management, audit committees, external auditors, analysts and investment advisors, investors, regulators and oversight bodies, and accounting standard setters. The Act requires changes by many participants in the financial reporting. Some of the important changes being implemented and studies being undertaken under the direction of the Act are: (1) required certification of information by company CEOs and CFOs, (2) empowerment of audit committees to engage and approve the services provided by independent auditors, (3) more stringent auditor independence standards, (4) greater oversight of auditors through the establishment of the PCAOB, (5) a study of whether investment banks played a role in the manipulation of earnings by some public companies, and (6) greater independence for the accounting standard setter.

To study the implications of principles-based standards, it is necessary to consider the entire context of financial reporting in the time period subsequent to the enactment of the Act. Stated differently, the standard setting approach is but one element of the reforms put in motion by the Act. Thus, an evaluation of the potential effectiveness of a principles-based

approach to standard setting must be made within the context of these other reforms.[10]

In particular, the reforms of the Act require management to accept responsibility for ensuring that the financial information provided to investors fairly presents the company's financial position, results of operations, and cash flows. Additionally, management is required to ensure that it has proper disclosure controls in place so that the company will be able to provide clear and transparent disclosure to investors of all material information.

Furthermore, through the PCAOB, the audit process and auditors will be more closely scrutinized. As the evaluation of auditors shifts from one of "peer review" to that of PCAOB inspection, it will place an additional premium on the auditors' ability to evaluate both compliance with generally accepted accounting principles ("GAAP") and the adequacy of a company's disclosures in light of the underlying economic substance of the company's transactions.

C. Defining Principles-Based Accounting Standards

To conduct a study of the adoption of principles-based standard setting in the U.S., we must first define principles-based. There are a wide variety of views on the meaning of that term. Accordingly, we have defined principles-based standards below in a manner consistent with what we would view as optimal adjustments to U.S. standards in this direction. This approach allows us to analyze such a shift with a reasonable degree of specificity.[11]

In our view, the optimal principles-based accounting standard involves a concise statement of substantive accounting principle where the accounting objective has been incorporated as an integral part of the standard and where few, if any, exceptions or internal inconsistencies are included in the standard. Further, such a standard should provide an appropriate amount of implementation guidance given the nature of the class of transactions or events and should be devoid of bright-line tests. Finally, such a standard should be consistent with, and derive from, a coherent conceptual framework of financial reporting.

To distinguish our vision of a principles-based approach to standard setting from those proposed by others, we refer to it as objectives-oriented standard setting. Standards established in such a fashion are objectives-oriented in a number of senses.

First, in applying a particular standard in practice, preparers (and auditors) are required to focus the accounting (and attestation) decisions on fulfilling the accounting objective of that standard. This minimizes the opportunities for financial engineering designed to evade the intent of the standard.

Second, each standard is drafted in accordance with objectives set by an overarching, coherent conceptual framework meant to unify the accounting system as a whole.

Third, this approach eschews exceptions, which by their very nature are

contrary to fulfilling a principled objective, create internal inconsistencies within the standard, and, inherently, create a need for more detailed guidance.

Fourth, it also eschews bright-line tests, which often are a product of the exceptions. These are inherently contrary to any principled objective, because a slight shift in the form or structure of a transaction can cause it to move across the threshold resulting in profoundly different accounting for transactions that are economically similar.

Finally, objectives-oriented standards clearly articulate the class of transactions to which they apply and contain sufficiently-detailed guidance so that preparers and auditors have a structure in which to determine the appropriate accounting for the company's transactions. In general, the possible degrees of specificity to which accounting standards may be drafted constitute a spectrum ranging from the abstract, at one end, to the very specific at the other. Objectives-oriented standards, when properly constructed, land solidly between the two ends of this spectrum.[12]

Objectives-oriented standards stand in contrast to rules-based accounting standards, which are characterized by bright-line tests, multiple exceptions, a high level of detail, and internal inconsistencies. The vision underlying a rules-based approach is to specify the appropriate accounting treatment for virtually every imaginable scenario, such that the determination of the appropriate accounting answer for any situation is straight-forward and, at least in theory, the extent of professional judgment necessary is minimized. Ironically, however, significant application of judgment remains necessary in a rules-based environment. The focus of that judgment, however, is not on capturing the economic substance of the transactions or events, but rather it is shifted to the determination of which of the accounting treatments within a complex maze of scope exceptions and often conflicting guidance is applicable.

An argument in support of the use of bright-line tests that are endemic to rules-based accounting standards is that the tests result in greater comparability across issuers since all are applying the same bright-lines. However, contrary to these beliefs, rules-based standards often create only illusory comparability because transactions falling just barely on opposite sides of the bright-line are generally very similar, but receive very different accounting treatments.

Unfortunately, experience demonstrates that rules-based standards often provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-lines tests reward those willing to engineer their way around the intent of standards. This can result in financial reporting that is not representationally faithful to the underlying economic substance of transactions and events. In a rules-based system, financial reporting may well come to be seen as an act of compliance rather than an act of communication. Moreover, it can create a cycle of ever-increasing complexity, as financial engineering and implementation guidance vie to keep up with one another.

Objectives-oriented standards also stand in contrast to what we refer to as principles-only (as contrasted with principles-based) standard setting, which might be defined as high-level standards with little if any operational

guidance.[13] A principles-only approach often provides insufficient guidance to make the standards reliably operational. As a consequence, principles-only standards typically require preparers and auditors to exercise judgment in accounting for transactions and events without providing a sufficient structure to frame that judgment.[14] The result of principles-only standards can be a significant loss of comparability among reporting entities.

In contrast to these extremes, objectives-oriented or principles-based standards charge management with the responsibility for capturing within the company's financial reports the economic substance of transactions and events-not abstractly, but as defined specifically and framed by the substantive objectives built into each pertinent standard. In turn, auditors would be held responsible for reporting whether management fulfilled that responsibility. Accordingly, objectives-oriented standards impose a greater responsibility on both management and auditors than do either rules-based standards or principles-only standards. Further, if properly constructed, objectives-oriented standards may require less use of professional judgment than either rules-based or principles-only standards, and thus, may serve to better facilitate efforts to enforce compliance with the standards.

Fundamental to this approach is that the objectives-oriented standards would clearly establish the objectives and the accounting model for the class of transactions, providing management and auditors with a framework that is sufficiently detailed for the standards to be operational. At the same time, such standards would provide users, as well as regulators and others who oversee or monitor the financial reporting process, with sufficient detail to comprehend and properly gauge the results reported by management and attested to by the auditors. In this manner, an objectives-oriented approach should provide the means by which management and auditors may be held accountable for reporting the substance of transactions within the financial statements.

Thus, on the one hand, objectives-oriented standards are superior to rules-based standards, because they avoid the pitfalls that may result in financial engineering to achieve desired accounting results. On the other hand, objectives-oriented standards are superior to principles-only standards, because they provide sufficient structure for preparers and auditors to make a determination of the appropriate accounting. As a consequence, we believe financial reporting based on objectives-oriented standards strikes an optimal balance and should increase both comparability and transparency of information as compared to either a principles-only approach or a rules-based approach to standard setting.

Some of the concerns that have been expressed about principles-based standards include: (1) a loss of comparability because of management and auditor discretion in the application of the principles, (2) a greater difficulty in seeking remedies against "bad" actors either through enforcement or litigation, and (3) a concern by preparers and auditors that regulatory agencies might not accept "good faith" judgments.[15] However, these concerns seem more founded as a critique of principles-only standards. Indeed, it is for these very reasons that we reject principles-only standards as an optimum standard setting paradigm.

In contrast to a principles-only approach, the framework for the application of professional judgment in an objectives-oriented regime is much narrower and provides a basis for more informative financial information to be provided to investors.[16] Indeed, properly constructed objectives-oriented standards have the potential to improve "actual" comparability as compared to either a rules-based or a principles-only approach,[17] since the application of an objectives-oriented standard is more likely to reflect the underlying economic substance of transactions or events, while the range within which professional judgment must be exercised is narrowed as compared to either a principles-only or a rules-based approach.[18] Indeed, with management and auditors held accountable for fulfilling the narrowly circumscribed substantive accounting objectives built into objectives-oriented standards, we believe that the degrees of freedom to achieve "desired" accounting results is minimized-relative to either a rules-based or a principles-only approach.[19]

D. The Role of Judgment in Applying Accounting Standards

Regardless of the approach that standard setters take to establishing accounting standards, there are, inevitably, many interpretive actions taken by management and the auditors in preparing and attesting to a company's financial statements. Indeed, the process of preparing the company's financial statements essentially constitutes a translation of economic reality into an accounting framework as defined by a set of standards. Likewise, attesting to the appropriateness of those financial statements requires the auditor to make an informed judgment as to whether the financial statements are representative of that economic reality, in accordance with a set of standards. This interpretive process necessarily involves judgment. By changing the focus of professional judgment to the objectives of the accounting standard, objectives-oriented standards allow accounting professionals to operationalize accounting treatments in a manner that best fulfills the objective of each standard and thereby best captures the underlying economic reality.

In contrast, inherent in a rules-based approach is an intent to minimize (and indeed in certain instances to trivialize) the judgmental component of accounting practice through the establishment of complicated, finely articulated rules that attempt to foresee all possible application challenges.[20] Unfortunately, this belief that judgment can be minimized or eliminated is a mistake for at least three reasons.

First and foremost, no standard setter can ever sufficiently identify the myriad of business situations to which accounting standards must be applied. As a consequence, it is virtually impossible for standard setters to construct accounting categories with sufficient refinement so as to be optimal for each and every situation encountered. Indeed, the more rigid and detailed accounting standards are, the less well they may fit the unforeseen specific facts associated with individual reporting companies' circumstances. In contrast, objectives-oriented accounting standards should provide a better balance of structure and flexibility that affords management and accountants the opportunity, and gives them the responsibility, to interpret company-specific facts in the manner that best conveys the underlying economic reality to investors.

Second, excessively detailed accounting standards fail to take advantage of the company-specific knowledge of the front-line professionals-management, accountants, audit committee members, and auditors-who are making the accounting judgments. Managements have access to much information that is crucial for quality financial reporting. Excessive efforts by standard setters to eliminate judgment sacrifice valuable information that might otherwise be offered by the most informed parties. Accounting standards must incorporate some flexibility within their structure-as do objectives-oriented standards-to best facilitate the capture of such knowledge.

Finally, it is simply impossible to fully eliminate professional judgment in the application of accounting standards.[21] To pretend that standards can be written in such a manner results in both unnecessary cost and a misplaced regulatory focus. No set of ever more complicated rules can substitute for the essential ingredients to the reporting process of professional integrity and accountability. Furthermore, as noted earlier, because of the exceptions and internal conflicts inherent in a rules-based system of accounting standards, judgment is not eliminated at all. Rather, the judgment shifts to a determination of which part of the contradictory rules should be applied.[22]

E. Accounting Standards in the Context of the Sarbanes-Oxley Reforms

An evaluation of the potential effectiveness of an objectives-oriented standard setting approach must be made within the context of the other reforms associated with the Act. In particular, the reforms of the Act require management to accept responsibility for ensuring that the financial information provided to investors fairly presents the company's financial position, results of operations, and cash flows. Additionally, management is required to ensure that it has proper disclosure controls in place so that the company will be able to provide clear and transparent disclosure to investors of all material information. Furthermore, through the PCAOB, the audit process and auditors will be more closely scrutinized. As the evaluation of auditors shifts from one of "peer review" to that of PCAOB inspection, it will place an additional premium on the auditors' ability to evaluate both compliance with GAAP and the adequacy of the company's disclosures in light of the underlying economic substance of the company's transactions. These changes coupled with greater empowerment of audit committees to engage and approve the services provided by independent auditors, more stringent auditor independence standards, and substantial penalties for violations[23] provide the context for an evaluation of objectives-oriented standard setting. Thus, the other reforms from the Act serve to re-inforce the incentives of management and auditors to provide more informative financial reporting.

The reforms associated with the Act are highly complementary to objectives-oriented standard setting. While objectives-oriented accounting standards hold preparers and auditors to a heightened degree of responsibility for the fulfillment of substantive, clearly-defined accounting objectives, the Act provides for the heightened monitoring and accountability that ensures most will be motivated to do so. For example, management certifications could be more meaningful when combined with objectives-oriented accounting standards, as the goal of fair presentation of

results would underly the objectives upon which standards are built. And while no regime can preclude fraud, we believe that objectives-oriented accounting standards also may better align the incentives of those who produce financial information with the interests of investors, which should result in more informative financial information. This, above all, is the underlying goal of the Act. Without the other reforms associated with the Sarbanes-Oxley Act, the potential benefits of objectives-oriented standards would be lower, while the associated costs would be higher.

F. Characterizing Current Accounting Standards Regimes

Many contend that U.S. GAAP provides an example of a rules-based approach to standard setting. However, we do not fully agree. While we agree that certain standards do suffer from the short-comings of a rules-based approach, many others are closer to the kind of principles-based approach we prescribe herein. Moreover, U.S. GAAP already is based on an explicit conceptual framework, albeit one in need of improvement.

That being said, we do take certain standards currently extant in the U.S. accounting literature as examples of rules-based standards. These include standards on derivatives, leases, and stock compensation. Many believe that these standards, which will be discussed in more detail later in this report, are far from the optimal point on the spectrum and would benefit from an objectives-oriented standard setting approach.

Many have pointed to International Financial Reporting Standards ("IFRSs"),[24] issued by the International Accounting Standards Board ("IASB") and selected for adoption in Europe by the European Commission ("EC"),[25] as an example of a principles-based regime. We do not believe the line of demarcation to be quite so simple. As they currently stand, the IFRSs do not embody the objectives-oriented approach to principles-based accounting standard setting. Indeed, a careful examination of the IFRSs shows that many of those standards are more properly described as rules-based. Other IFRSs could fairly be characterized as principles-only because they are overly general.[26] Accordingly, we reject the notion that IFRSs constitute a model for principles-based accounting standards.

G. An Example of a Rules-Based Standard

One conclusion of this study is that the existence of numerous exceptions and voluminous detailed guidance, as characterizes a rules-based standard, often leads to inconsistencies in the application of the standard Such standards may contain conflicting guidance and, because preparers and auditors may have different interpretations about which application of the literature is appropriate, there can be inconsistent accounting among companies for similar transactions.[27] Moreover, the bright-line tests that demarcate the exceptions provide a roadmap for financial engineers to achieve desired accounting results. A consequence of such financial engineering is that transactions that are substantively the same may receive very different accounting. Some have argued that rules-based standards help achieve greater comparability in reporting. In reality, because of the inherent inconsistencies and bright-lines, comparability in reporting can be illusory.

To illustrate, consider an example of accounting for a business combination.[28] Accounting Principles Board ("APB") Opinion No. 16 concluded that both the pooling of interests method and the purchase method were appropriate methods in accounting for business combinations. However, in reaching that conclusion, the APB specified 12 criteria, all of which must be met, in order for a combination to be accounted for as a pooling of interests.[29] A combination that failed to meet one or more of those criteria was accounted for as a purchase.[30] These criteria were almost all bright-line tests. For example, if a company acquired 90% of another company through an exchange of stock, pooling of interests was possible, but if it acquired only 89%, pooling was not possible. Pursuant to another test, the issuance of one share of restricted stock to an employee during certain periods could turn a transaction from a pooling to a purchase.

The purchase method and the pooling of interests method yield dramatically different financial reporting results. The purchase method reflects the business combination at fair value-that is, the amount paid by the acquiring company-while the pooling of interests method relies on book value. Because of this dramatic difference in reporting, financial engineers were sometimes eager to structure combinations in a manner that met the pooling of interests requirements. Inevitably, this led to a demand for increased guidance on the application of the pooling of interests criteria, which, in turn, led to increasingly complex and detailed guidance. Nonetheless, because of the significant difference in financial reporting under the two methods, companies often were willing to incur the cost and effort needed to navigate the difficult path to achieve a desired accounting result (pooling of interests)-despite the fact that the basic transaction, the combination of two entities, was not altered by the accounting method.

Consider a numerical illustration. Assume that Company A acquires Company B through the exchange of voting stock. The value of the exchange to Company A is $1,000 and the book value of Company B's net assets is $400. Further, assume that in the first year after the acquisition, Company B has net income of $300 (based on Company B's underlying book value). Let us also assume that the $600 difference between Company B's book value and the fair value of the combination is attributable to identifiable assets that are depreciated or amortized over six years. Under the pooling of interests method, the income that would be reported from Company B's operations would be $300. If, however, the combination were reported as a purchase, the income that would be reported from Company B's operations would be $200 ($300 minus $100 of additional depreciation/amortization). In either case, however, the related cash flows and economic value of Company B's operations to Company A would be the same.

Thus, the presence of the pooling of interests alternative, and the rules associated with it, rendered illusory the comparability in financial reporting for business combinations. Obviously, the underlying economic reality for a given transaction was the same regardless of whether the transaction was accounted for as a pooling of interests or a purchase. Nonetheless, there is evidence to suggest that investors' assessments of the company were affected by the difference in reporting.[31]

H. An Outline of the Study

Section II of this study provides the historical background to accounting standard setting in the U.S., including a description of the current conceptual framework and the roles of the various participants in the standard setting process. Section II also details the current status of U.S. standards with respect to the extent to which they might be deemed as principles-based or, alternatively, rules-based.

Section III covers the components of an objectives-oriented principles-based approach to standard setting.

Section IV covers the practical issues raised in the implementation of an objectives-oriented principles-based approach to standard setting.

Section V provides the economic and policy analysis of adopting objectives-oriented standards in the U.S. The issues that bear on this analysis are: improved accessibility to and informativeness of financial information for investors; better alignment of preparer and auditor incentives with investors' interests; enhanced quality, consistency and timeliness of standard setting; the provision of a vehicle for convergence with international accounting standards; cost of accounting services; comparability issues; litigation uncertainty, and transition costs.

Section VI provides the conclusion, and includes a chart that provides time horizons for the various action items necessary to continue a movement in the direction of principles-based accounting standard setting in the U.S.

II. Historical Background

A. Development of Accounting Standards

i. Development of Promulgated Standards

The Commission has the authority to establish accounting principles to be used in financial statements filed with the Commission.[32] Additionally, the Commission has made clear that financial statements filed with the Commission should not be misleading to investors. In that regard, the Commission has stated in Accounting Series Release ("ASR") No. 4:

> In cases where financial statements filed with the Commission pursuant to its rules and regulations under the Securities Act or the Exchange Act are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material.[33]

While ASR No. 4 made clear that only accounting principles having "substantial authoritative support" would be appropriate for inclusion in financial statements filed with the Commission, the question at hand was what body should be responsible for establishing such principles. The Commission's first Chief Accountant, Carman G. Blough, stated that if the profession wanted to retain the ability to determine accounting principles and methods, it would be up to the profession to issue statements of

principles that could be deemed by the Commission to have "substantial authoritative support."[34]

In response to this challenge to the profession, the American Institute of Accountants[35] ("AIA") gave to its Committee on Accounting Procedure ("Committee") the responsibility for establishing accounting principles and the authority to speak on behalf of the Institute on matters of accounting principles. It was intended that the Committee would serve as the principal source of "substantial authoritative support" for accounting principles.

From 1939 to 1959, the Committee issued a series of Accounting Research Bulletins ("ARBs") intended to establish "substantial authoritative support" on a variety of issues. While the Committee had some success in narrowing divergence in practice on certain issues, it ultimately was unable to develop a set of principles that could serve as the basis or framework for establishing specific standards. This resulted in a standard-setting process often described as piece-meal, since its standards were not based on a consistent, underlying theme or framework. Additionally, there were ongoing challenges to the Committee's authority since, as the Committee acknowledged, the authority of its standards rested on their general acceptability.[36]

In an attempt to address some of these shortcomings, the AICPA, successor to the AIA, reorganized its standard setting activities in 1959. As reconstituted, the AICPA established the APB to replace the Committee and gave the APB the authority to issue accounting standards. Additionally, the AICPA had a vision that the APB would develop a definitive statement of accounting principles upon which subsequent standard setting could be based. In particular, the AICPA's Special Committee on Research Program envisaged a hierarchy of postulates, principles, and rules to guide the APB's work:

> The broad problem of financial accounting should be visualized as requiring attention at four levels: first, postulates; second, principles; third, rules or other guides for the application of principles in specific situations; and fourth, research.
>
> Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession should make clear its understanding and interpretation of what they are, to provide a meaningful foundation for the formulation of principles and the development of rules or other guides for the application of principles in specific situations.[37]

The APB began an effort to establish a set of postulates and principles upon which standards could be based. Unfortunately, the APB was unsuccessful in doing so[38] and, thus, its standard setting efforts were similar to its predecessor. Not surprisingly, the APB suffered from many of the same criticisms as had been leveled against the Committee on Accounting Procedure.

In 1973, a new organization independent of the AICPA, the Financial Accounting Foundation ("FAF"), was created to oversee the standard setting process. The body created under the FAF to carry out that standard setting activity was the Financial Accounting Standards Board. In an attempt to more clearly define the authority of the FASB for establishing accounting standards for use in financial statements filed with the Commission, the Commission issued the following statement:

> Various Acts of Congress administered by the Securities and Exchange Commission clearly state the authority of the Commission to prescribe the methods to be followed in the preparation of accounts and the form and content of financial statements to be filed under the Acts and the responsibility to assure that investors are furnished with information necessary for informed investment decisions. In meeting this statutory responsibility effectively, in recognition of the expertise, energy, and resources of the accounting profession, and without abdicating its responsibilities, the Commission has historically looked to the standard-setting bodies designated by the profession to provide leadership in establishing and improving the accounting principles. The determinations by these bodies have been regarded by the Commission, with minor exceptions, as being responsive to the needs of investors.
>
> The body presently designated by the Council of the AICPA to establish accounting principles is the FASB. . . .
>
> In ASR 4, the Commission stated its policy that financial statements prepared in accordance with accounting practices for which there was no substantial authoritative support were presumed to be misleading and that footnote or other disclosure would not avoid this presumption. . . . For purposes of this policy, principles, standards, and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support and those contrary to such FASB promulgations will be considered to have no such support.[39]

Armed with that statement of support, the FASB embarked on its standard-setting activities.[40] In so doing, the FASB's initial efforts were directed along two different tracks. On the one hand, the FASB issued standards addressing specific transactions and events. Additionally, the FASB undertook a major effort to establish a conceptual framework of financial reporting.

The results of the deliberations on the conceptual framework by the FASB are found in its Statements of Financial Accounting Concepts ("Concepts Statements").[41] The FASB noted that the primary purpose of the conceptual framework is "to establish the objectives and concepts that the [FASB] will use in developing standards of financial accounting and reporting."[42]

ii. Current Role of Conceptual Framework in Standard Setting

The FASB issued its Concepts Statements in large part to provide it with a framework for developing its subsequent standards. To be sure, to the extent that the FASB does develop standards based on its conceptual framework, it achieves some measure of success in having standards that are principles-based.[43] In an effort to demonstrate that its standards are, indeed, grounded in its conceptual framework, the FASB has begun to include in its standards a discussion of how the standard relates to and is based upon the conceptual framework.[44]

It is important that the FASB issue standards that are based on its conceptual framework. However, as currently constructed, the conceptual framework does not always provide a complete roadmap to guide the standard setters to that optimal point on the continuum.[45] Thus, not surprisingly, an examination of the current body of literature reveals that there are standards that are relatively principles-based while there are other standards that are more rules-based. Further complicating the standard setters' efforts to issue standards at the optimum point on the continuum is that there have been multiple standard setting bodies.

iii. Current Role of AcSEC, the EITF, and the FASB Staff[46]

The current GAAP hierarchy identifies several different bodies with the ability to issue authoritative accounting standards.[47] In addition to the FASB, the AICPA's Accounting Standards Executive Committee ("AcSEC"), the Emerging Issues Task Force ("EITF"),[48] and the FASB staff have the ability to issue standards that are included within the body of literature designated as authoritative.

AcSEC currently has the ability to issue Statements of Position ("SOPs"), Industry Audit and Accounting Guides, and Practice Bulletins,[49] all of which are included within the GAAP hierarchy.[50] Many of these documents focus on specific industry issues. The proliferation of "specialized industry standards" creates two problems that can hinder standard setters' efforts to issue subsequent standards using a more objectives-oriented regime:

- The existence of specialized industry practices may make it more difficult for standard setters to eliminate scope exceptions in subsequent standards (e.g., many standards contain exceptions for insurance arrangements subject to specialized industry accounting)

- The specialized standards may create conflicting GAAP, which makes it more difficult for accounting professionals to determine the appropriate accounting.

Consensus positions reached by the EITF constitute authoritative guidance. The EITF was formed in 1984 in response to the recommendations of the FASB's task force on timely financial reporting guidance and an FASB Invitation to Comment on those recommendations. Members of the EITF are drawn primarily from public accounting firms but also include representatives of industry nominated by the Financial Executives Institute, the Institute of Management Accountants, the Business Roundtable, and, most recently, the user community. In an effort to achieve the goal of providing timely guidance, the EITF has considered in excess of 20 issues per year, on average. Thus, the activities of the EITF, while often timely

and valuable, have contributed to a proliferation of standards often containing very detailed guidance.

Lastly, the staff of the standard setter has the ability to provide formalized guidance on the application of existing standards.[51] Historically, the FASB staff has addressed these questions either through staff announcements[52] or through the issuance of Q&As.[53]

iv. Role of the SEC

Under the securities laws, including the Act, the Commission has the responsibility to develop accounting standards to be used by public companies. Despite the fact that it has consistently looked to the private sector for assistance in this task, the SEC retains the authority to establish standards if it so chooses. The SEC's authority would allow it to overturn an FASB standard by passing a Commission rule. This authority has rarely been used.

B. Current Status of U.S. Standards

i. Examples of Rules-Based Standards

An examination of the U.S. literature reveals that there are certain standards (and related interpretive guidance) that are rules-based. In particular, there are four topics for which the bodies of literature are often thought of as being overly rules-based. These are: accounting for leases, accounting for derivatives and hedging activities, stock-based compensation arrangements, and derecognition of financial assets and liabilities.[54] As we have noted previously, the primary characteristics of rules-based standards are the existence of exceptions and bright-lines which lead to very detailed implementation guidance, which often leads to even more bright-lines.[55]

Consider these bodies of literature in that context. Paragraphs 10-11 of SFAS No. 133 list nine exceptions to its scope. In part, the demand for increased implementation guidance was created by the scope exceptions. Currently, there are 15 Derivative Implementation Group ("DIG") issues related to the application of those scope exceptions.[56] Of course, the detailed implementation guidance on derivatives does not stop with the question of scope. In total, there are over 800 pages of guidance on accounting for derivatives.[57]

The lease accounting literature provides another example of a rules-based standard. The lease literature is composed of 16 FASB Statements and Interpretations, nine Technical Bulletins, and more than 30 EITF Issues. Additionally, the fundamental standards for classifying a lease as capital vs. operating are predicated on the use of bright-lines (e.g., in classifying a lease as a capital lease it must meet one of four tests; two of which contain strict percentage thresholds (75% and 90%)).

The literature on stock-based compensation allows for either a fair value or an intrinsic value approach to accounting for employee stock-based compensation. Additionally, within the intrinsic value model, there is a

sharply different accounting answer if the arrangement is a fixed award vs. a variable award. This distinction has fueled the demand for increased guidance.[58]

Likewise, the literature on derecognition of financial assets and liabilities has been criticized as overly rules-based. In addition to the guidance found in SFAS No. 140,[59] the FASB issued a Technical Bulletin to clarify certain aspects of SFAS No. 140. Also, the FASB staff issued a Q&A containing 123 paragraphs plus tentative guidance on qualifying SPEs containing six additional questions and answers.

Other standards contain many of these same shortcomings. For example, bright-lines are stated (or implied)[60] in standards such as:

- Consolidation - 50%[61]
- Consolidation of SPEs - 3%[62]
- Corridor used for "smoothing" gains or losses on defined benefit pension plans - 10%[63]
- Down payment needed to achieve full accrual profit recognition method on sales of real estate - 5%, 10%, 15%, 20%, or 25% depending upon the type of real estate being sold.[64]

Additionally, detailed implementation guidance has been provided by the FASB staff on issues such as:[65]

- Pensions and postretirement benefits[66]
- Accounting for income taxes.[67]

While other examples could be provided, it is clear that portions of the U.S. authoritative literature are located towards the overly-specific end of the spectrum, past the optimal point.

ii. Examples of Principles-Based Standards

Having noted that there are a number of extant standards that are more rules-based, it also is fair to say that some standards are closer to a principles-based regime. (Note that we are using the term principles-based here to describe standards that approach the ideal variant we have labeled objectives-oriented.) Beginning with the issuance of SFAS No. 141, the FASB has included in its standards a discussion of how the standards improve financial reporting and how the conclusions in the standard relate to the conceptual framework. Not surprisingly, then, we find that SFAS Nos. 141 and 142[68] are examples of standards that are principles-based. Indeed, while the standards do not take on the exact format that we describe later, they do contain most of the fundamental elements of objectives-oriented standards. In particular:

- Few, if any, scope exceptions-SFAS No. 141 contains a scope

exception for certain business combinations involving not-for-profit entities and mutual entities

- Use of an asset/liability view-SFAS No. 141 requires the recognition of all assets and liabilities acquired in the business combination
- Absence of bright-lines-SFAS No. 142 contains no maximum amortization period for intangible assets
- A modicum of implementation guidance-SFAS Nos. 141 and 142 contain appendices that provide implementation guidance and bases for conclusions.

Other recently issued standards comply with aspects of the objectives-oriented approach as well. Examples include SFAS Nos. 143 (asset retirement obligations), 144 (impairment of long-lived assets) and 146 (liabilities for existing activities). Furthermore, some of the older standards can be described as relatively principles-based as well. Examples include ARB No. 43, Chapter 4 (accounting for inventory), SFAS Nos. 34 (interest capitalization) and 52 (foreign currency translation).

iii. Examples of Principles-Only Standards

Even as there are and have been some standards that are rules-based, there also are and have been some that are principles-only. As we noted previously, standards that are principles-only typically do not provide sufficient framework for the application of judgment. Examples of principles-only standards are:

- Impairment of long-lived assets-a loss was to be recognized when the value of the assets were deemed to be impaired; however prior to the issuance of SFAS No. 121, there was no guidance for making that determination.
- Historical cost of depreciable assets-depreciable assets are recorded at their historical cost at the time of acquisition. Historical cost is defined as all costs necessary to bring the asset to its location and condition for use.

As these examples demonstrate, principles-only standards establish the basic principle but may not provide sufficient guidance for implementation. The outcome can be a loss of comparability.

III. Components of Objectives-Oriented Standard Setting

A. Relevance, Reliability, and Comparability

The FASB's conceptual framework is predicated on the fundamental notion that the information provided through financial reporting should be useful to investors in making investment decisions.[69] In its standard setting activities, the FASB must make determinations about appropriate accounting in light of this decision-usefulness criterion.

The FASB also must establish standards consistent with the qualitative characteristics of accounting information as defined in Statement of Financial Accounting Concepts ("SFAC") No. 2. In SFAC No. 2, the FASB established relevance and reliability as the primary decision-specific qualitative characteristics and comparability as a secondary qualitative characteristic.[70] The challenge for the standard setters, of course, is not in coming to an agreement that accounting information should be relevant, reliable, and comparable. Rather, the challenge is in making the trade-off among these three characteristics. SFAC No. 2 discusses the issue of trade-offs as follows:

> Although financial information must be both relevant and reliable to be useful, information may possess both characteristics to varying degrees. It may be possible to trade relevance for reliability or vice versa, though not to the point of dispensing with one of them altogether. Information may also have other characteristics . . . to varying degrees, and other trade-offs between characteristics may be necessary or beneficial.[71]

Thus, a key responsibility of the standard setters is to make the determination as to the trade-offs among the qualitative characteristics of accounting information to ensure that the information portrayed in the financial statements is representationally faithful to the underlying substance of the transaction or event and can be portrayed to investors in a manner that is understandable to them. In practice, making these trade-offs in setting standards is closely intertwined with the problem of defining the scope of a standard and, more fundamentally, with the use of the asset/liability view to standard setting.

B. The Asset/Liability View

Before discussing specific implementation issues associated with the adoption of a more objectives-oriented regime in the U.S., it is necessary to examine an even more fundamental aspect of standard setting regarding the definition and classification of the basic elements of accounting. The question is: what are the fundamental building blocks of accounting standards? Broadly speaking, there are two basic approaches to definitional issues that standard setters can use in establishing standards: (a) the asset/liability view or (b) the revenue/expense view.

In the asset/liability view, the standard setter, in establishing the accounting standard for a class of transactions would, first, attempt to define and specify the measurement for the assets and liabilities that arise from a class of transactions. The determination of income would then be based on changes in the assets and liabilities so defined.[72] Thus, in this view, the accounting for transactions and events involves identifying assets and liabilities, and changes in those assets and liabilities, associated with the underlying transactions and events.[73]

Conversely, the revenue/expense view would call upon the standard setter to establish standards that give primacy to the direct measurement and recognition of the revenues and expenses related to the class of transactions. Under this approach, the balance sheet becomes residual to

the income statement, and contains assets, liabilities, and other accruals/deferrals[74] needed to maintain a "balance sheet."[75]

From an economic perspective, it would seem that these two approaches should be the same since, from a conceptual perspective, revenues and expenses are simply incremental changes to assets and liabilities. Thus, whether revenues and expenses are defined in terms of assets and liabilities or vice versa, the results should be the same. From a practical accounting standard setting perspective, however, the selection of one starting point over the other is of considerable significance.

Under a revenue/expense view, scope tends to be defined either at too broad a level or at too narrow a level. To illustrate, consider the current literature applicable to revenue recognition. At one extreme, there is the very broad guidance: revenue should be recognized when it is earned and realized (or realizable).[76] At the other end of the spectrum are an array of specific revenue recognition standards which address the accounting for narrowly-defined transactions or industries.[77] Not surprisingly, an examination of these standards shows that various inconsistencies exist among the revenue recognition models.[78]

We believe that the revenue/expense view is inappropriate for use in standard setting-particularly in an objectives-oriented regime. In establishing an accounting standard, the standard setter is attempting to define and establish the accounting principles for the underlying economic substance of the class of transactions under consideration. As noted above, from an economic perspective, income represents a flow of, or change in, wealth during a period. Without first having an understanding of the wealth at the beginning of the period, it is not possible to determine the change in wealth during the period. The accounting equivalent to identifying "wealth" is identifying the assets and liabilities related to the class of transactions. This identification of wealth acts as a conceptual anchor to determining revenues and expenses that result from the flow of wealth during the period. Historical experience suggests that without this conceptual anchor the revenue/expense approach can become ad hoc and incoherent.

We see the optimal scope of a standard as being established by identifying assets or liabilities that, by virtue of their economic similarity, render a standard the most meaningful. Recognition and measurement questions should turn on that same economic underpinning.[79] As noted above, historical experience suggests that the asset/liability approach most appropriately anchors the standard setting process by providing the strongest conceptual mapping to the underlying economic reality. Thus, we believe that this asset/liability foundation is crucial not only to the FASB's efforts to establish when identified assets and liabilities should be recognized and how they should be measured, but also to defining the optimal scope of a standard-that is, what transactions or events should be addressed by a standard.

C. The Theory of Optimal Scope

We have posited that an objectives-oriented standard should have few, if any, scope exceptions.[80] As previous discussion highlighted, one of the factors that creates increased complexity and a tendency towards a rules-

based approach to standard setting is the existence of scope exceptions in a standard.[81] To illustrate, consider SFAS No. 133. Paragraphs 10 and 11 contain nine different scope exceptions. In an effort to further clarify the application of some of those scope exceptions, the FASB has found it necessary to issue two amending documents-SFAS Nos. 138 and 149. Additionally, there are 15 DIG Issues related just to the issue of the scope of accounting for derivatives. Clearly, a consequence of scope exceptions is increased complexity and the need for more rules.

In reality, establishing the proper scope of the standard is one of the more difficult challenges. The scope of a standard could range from very broad to very narrow. If the scope is too broad, the standard setter would be unable to provide sufficient guidance for the standard to be meaningful and useful to preparers and auditors.[82] This is apt to generate a proliferation of exceptions. However, if the scope of the standard is too narrow, it would not have sufficient applicability to justify the time and effort of the standard setter, and may not capture all transactions with similar economic substance.

How, then, is the standard setter to determine the optimal scope of a standard-the point at which the scope is sufficiently broad so as to be applicable to an appropriate group of economic transactions and events, but not so broad that numerous scope exceptions are needed? Clearly, a starting point to that process must be an understanding by the standard setter of the underlying economics of the transaction or event under study. Additionally, the standard setter must determine how that transaction or event affects the financial position of the company. From there, the standard setter can develop a standard that captures the underlying economics of the transaction or event, as defined by the standard setter, and specifies how and when the impact on financial position should be reported in earnings. Ultimately, it is the underlying economic substance that must drive the development of the scope of standards, if these standards are to remain stable and meaningful.

Thus, the standard setter must first be able to determine what assets and liabilities are created, eliminated, or changed by the transaction or event under consideration. As discussed previously, doing so necessitates that the standard setter adopt an asset/liability view when establishing accounting standards. It is the task of the standard setter to determine the appropriate trade-offs among relevance, reliability, and comparability within the context of the asset/liability view. Thus, in the final analysis, the theory of optimal scope is an effort to find the "sweet spot"[83] on the continuum, which appropriately applies the asset/liability view, while selecting the proper trade-off among relevance, reliability and comparability.

When the standard setter succeeds in defining the optimal scope of a standard, it develops standards devoid of scope exceptions and bright-lines, and significantly increases the likelihood that the standard will result in accounting that is more representationally faithful in capturing the substance of the related class of transactions or events.[84] Furthermore, it minimizes the opportunities for "gaming" the system by those who wish to engage in financial engineering.

The following section illustrates the theory of optimal scope by way of a

standard setting example.

D. Illustration of the Use of Optimal Scope Theory

To illustrate this concept, consider the example of the FASB's standards on business combinations-SFAS No. 141.[85] As we noted earlier, this standard is illustrative of standards which are near the optimum point on the continuum and, thus, can be described as objectives-oriented.[86] In establishing a standard on business combinations, the FASB defined a business combination as follows:

> A business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities.[87]

Included in this description are several important concepts which are critical to the conclusions in the standard. First, there is the notion that the entity must acquire control over another entity or business. Control brings with it the notion that the acquiring entity should consolidate its investment in the acquired business subsequent to the business combination.[88] Thus, the FASB does not need to exclude the acquisition of investments accounted for by the equity method from the scope of the standard because, by definition, the acquisition of an equity method investee does not give rise to control. A similar decision was made by the APB when it addressed the issue of accounting for business combinations in Opinion No. 16.

Where the FASB and APB diverge, however, is in applying the concepts that are developed in articulating the scope to the establishment of the accounting standards. The FASB, by drawing upon the concepts that were developed in the articulation of the scope of the standard established a standard that is more representationally faithful to the underlying substance of the transactions-specifically, that in a business combination, one company acquires another. Thus, not surprisingly, SFAS No. 141 concludes that there is only **one** method to account for a business combination - the purchase method. APB Opinion No. 16 had specified that a business combination could be accounted for as either a purchase or a pooling of interests if the pooling criteria were met. Thus, APB Opinion No. 16 established an exception to its fundamental concept-that one company acquires another in a business combination.

The FASB, on the other hand, by establishing a clear definition of scope and applying an asset/liability view to the transactions included within that scope, established a standard without the need for numerous scope exceptions and bright-lines.[89] The contrast between the rules-based approach used in APB Opinion No. 16 and a more principles-based approach used in SFAS No. 141 is illustrated in the following table.[90]

Comparison of Accounting Standard on Business Combinations Using Rules-Based (APB Opinion No. 16), Principles-Only, and Principles-Based (SFAS No. 141) Standard Setting

Elements of	Rules-Based (APB	Principles-	Principles-Only

Standard	Opinion No. 16)	Based (SFAS No. 141)	
Basic principle: a business combination occurs when one entity obtains control over the operations of another entity or business	Yes-standard addresses accounting and reporting for business combinations	Yes-standard addresses accounting and reporting for business combinations	Yes-standard addresses accounting and reporting for business combinations
Objectives of standard clearly stated within the standard	No	Yes	No
Scope of standard clearly articulated	No	Yes	No
Sufficient guidance included in the standard	N/A	Yes	No
Numerous scope exceptions	Yes	No	No
Bright-lines	Yes-12 criteria for classifying combination as a pooling of interest	No-bright-lines eliminated; all combinations accounted for using the purchase method	No
Detailed implementation guidance included standard	Yes	No	No
Need for significant amount of subsequent guidance	Yes-Subsequent to the issuance of APB Opinion No. 16, additional detailed guidance was provided by, among others, the SEC staff through Staff Accounting Bulletins, the AICPA staff through AICPA interpretations, the EITF through numerous consensuses.	No	Not provided
Business combination defined	No	Yes	No
	No-Because of the bright-line tests for		No-With the lack of sufficient structure

Comparability achieved	determining whether a business combination was a pooling of interest, two combinations could be essentially the same economically, but have completely different accounting (see, Section I.G for a more complete discussion)	Yes	and guidance in the standard, the resulting application of judgment would likely result in different accounting for similar transactions since there would be no framework for applying the needed judgment

E. Implementation Guidance

It is evident that there is a demand among accounting professionals for implementation guidance. This can be seen in the number of issues that are addressed each year by the EITF, the number of inquiries that the staffs of the FASB and SEC receive, and the volume of non-authoritative guidance that is published each year.[91] The question is not whether such guidance will be provided, but when and by whom. Ultimately, under an objectives-oriented regime, there will still need to be guidance provided both at the time a standard is issued and subsequently.

Who has the responsibility for such guidance and its authoritativeness are key questions.[92] (We further address this issue in Section IV.) We believe that the standard setter should make it clear that any implementation guidance included within a standard has the same level of authoritativeness[93] as the standard itself since the standard setter is making a judgment contemporaneously with the development of the standard as to the amount of implementation guidance needed to operationalize the standard. Regarding the guidance itself, clearly, the standard setters should provide some implementation guidance as a part of a newly issued standard. We believe, however, that the amount of detail provided by the standard setter under an objectives-oriented regime would likely be less than that provided under a rules-based regime. Otherwise, the guidance would quickly transform what could be an objectives-oriented regime back into a rules-based regime, with all the consequent disadvantages discussed herein.

F. Legacy Scope Exceptions

One of the potential challenges to transitioning from a rules-based to a principles-based regime is the question of how to deal with existing standards-particularly existing specialized industry standards-when the standard setter is in the process of developing a new or revised standard. One school of thought says that the standard setters should include "legacy" exceptions in its objectives-oriented standards. For example, a new standard might exempt insurance arrangements or investment companies or registered broker/dealers because there are specialized accounting standards applicable to those industries.

The danger in doing so is that, until those industry issues are addressed, comparability is hampered since companies in different industries with

similar transactions may account for them differently. Furthermore, providing these legacy exceptions may create an incentive to avoid the application of the newer standard (e.g., a company could argue that it has an insurance product and, therefore, should be excluded from the scope of the standard under an exception for certain insurance products).

We recognize that transitioning from a rules-based to an objectives-oriented regime will take time and will involve delicate choices by the standard setters. We do not recommend a policy to either totally ban or to uniformly allow legacy exceptions. Rather, we believe that the standard setters should judiciously determine when it is appropriate to allow a legacy exception to its objectives-oriented standards. This will mean that the standard setters will need to weigh the costs resulting from the lack of comparability with the benefits of certain companies not having to undergo the change in accounting policy.

G. No True and Fair Override

Some have suggested that a necessary component of principles-based standards is the inclusion of a "true and fair override."[94] A true and fair override would permit a company to depart from accounting principles established by the standard setter (thus "overriding" those standards) if the override results in a "true and fair" presentation of the company's financial position, results of operations and cash flows.[95]

While we believe that it is important for preparers and auditors to determine that the financial statements clearly and transparently provide information to investors that allows them to evaluate the company's financial position, results of operations, and cash flows, we do not believe that a "true and fair override" is a necessary component of a principles-based or objectives-oriented standard setting system. In fact, we would expect that an objectives-oriented standard setting regime should reduce legitimate concerns about the established standards not providing appropriate guidance, as the standards should be based on objectives that would almost certainly not be met by a presentation that was not "true and fair".

While this view might seem, on the surface, to be inflexible, it is, in fact, grounded in the objectives-oriented standard setting model. There are various ways that the economics of an arrangement can be viewed and evaluated. Reasonable people can reasonably disagree on the economics of an arrangement. It is, however, precisely the role of the standard setter to define the class of transactions included within the economic arrangement and to then establish the appropriate accounting for that class of transactions. While not everyone will agree with the standard setter's conclusions, making the determination of the underlying economics of an arrangement and the appropriate accounting for that arrangement are integral to the standard setter's role. Thus, we believe that when the standard setter establishes standards under an objectives-oriented regime, the accounting should, in virtually all cases, be consistent with the standard setter's view of the nature of the economic arrangement.

H. Form of Objectives-Oriented Standard

To this point, we have discussed the key characteristics of accounting standards that are developed under an objectives-oriented regime. The determination of exact format of a standard (whether objectives-oriented or rules-based) is, ultimately, the responsibility of the standard setter. However, we believe that an objectives-oriented standard should contain the following elements:

- Brief summary of the standard
- The standard, including:
  - Objectives
  - Substance (or body) of the standard
  - Effective date and transition provisions
  - Basis for conclusions
  - Implementation guidance (consistent with previous discussion).[96]

I. Behavioral Changes

As the analysis in this study indicates, we believe that a continuing shift to an objectives-oriented regime could result in a net benefit to the FASB's constituents. It would result in standards that are more consistent with the FASB's conceptual framework. As we demonstrate in Section V, this should, in turn, result in accounting information that is more decision-useful to investors. This will necessitate a change in behavior, however, not just by the standard setters, but also by preparers, auditors, and investors.

i. Exercise of Professional Judgment

One consequence of continuing to move to an objectives-oriented regime is that preparers and auditors would be called upon to exercise professional judgment in a different way than is currently required.[97] There are at least two identifiable consequences to this.

First, there is the short-run consequence. Preparers would need to resist the temptation to challenge auditors by demanding written guidance in order to accept an auditor's judgments.[98] Additionally, preparers could not rely on financial engineering of structures to achieve a desired accounting result.[99] As a corollary to that, auditors would need to be weaned away from the check-list mentality. Since auditors would need to make sure that the accounting is consistent with the objective, rather than that it meets a specific set of rules, auditors will, in some cases, be faced with the prospect of having the rules-based security blanket removed.[100]

Second, there is the long-run consequence. Since the application of an objectives-oriented regime relies on preparers and auditors' ability to identify the objectives of the standard (as well as the specific guidance) and match that to the underlying transaction or event, there is a need to train

preparers and auditors in understanding the substance of the class of transactions. Additionally, it appears likely that in moving to a more objectives-oriented regime, the FASB will issue more standards that rely on fair value as the measurement attribute. If so, it would be imperative that accounting professionals be trained in valuation theory and techniques.

ii. More Transparent Disclosure

As we demonstrate in Section V, under an objectives-oriented regime, there is a greater incentive for management to "tell its story." We posit that an objectives-oriented regime creates an incentive for good companies to be more forthcoming in providing clear and transparent information to investors.[101] Doing so should, in turn, result in information that is more understandable (and, hence, more useful) to investors.[102]

Furthermore, under an objectives-oriented regime, users have a greater incentive to participate in the standard setting process. Since, under an objectives-oriented regime, the discussion is not focused so much on intricate details surrounding the application of the standard, users should have a greater ability to engage in the process. The barrier to entry into this discussion is therefore lowered. Thus, if the standard setting body is able to reach out to key user stakeholders to engage them in the process, there is a greater likelihood that standards would be issued which result in accounting information that is more meaningful to users.[103] And, as preparers are incented to get their story out to investors in a manner that reflects the economic substance of the company's financial position and results of operations, preparers should be willing to provide more transparent disclosure. This, in turn, should provide an incentive to users both to study the information with greater diligence and to participate more actively in the standard setting process.

J. Enforcement[104]

An objectives-oriented regime should create incentives for companies with "good stories to tell" to do so in a clear and transparent manner. However, another question remains: under an objectives-oriented regime, what is to prevent those who do not have a good story to tell from fabricating a good story? In reality, there are two primary gate-keepers. The first gate-keepers are the independent auditor and the company's audit committee.[105] As we noted earlier, the reforms contemplated by the Act require changes in behavior for the auditor and greater vigilance by the audit committee.[106] Indeed, the Commission has demonstrated a willingness to hold auditors accountable when they fail to uphold their gate-keeping role.[107] Thus, the recent strengthening of both the role of the audit committee and the auditor independence rules by the Act and the Commission's related rule-making are important components in making objectives-oriented standards effective.

That, of course, leads us to the second gate-keeper-the enforcement bodies. It has been argued that a principles-based regime in place in the U.K was not successful until coupled with an effective enforcement mechanism.[108] Research also has shown that strong enforcement coupled with flexibility in reporting can be advantageous to investors.[109] We provide further support for this proposition in Section V.

We believe that the existence of a strong and consistently applied enforcement mechanism is a necessary component to the success of an objectives-oriented system. Preparers and auditors have expressed concern that those charged with enforcement in a principles-based environment will question reasonable judgments made in good faith.[110] In fact, some have asked whether the Commission staff would be willing to accept reasonable views and interpretations by preparers and auditors in the application of accounting principles.[111]

In the event that a preparer's or auditor's accounting is questioned in an enforcement investigation under an objectives-oriented regime, the issue ultimately should be whether the judgments made were supported based on the facts and circumstances available at that time, just as it is now. Thus, it would seem prudent for preparers and auditors not only to make appropriate judgments on the application of the standards to their facts and circumstances, but also to document, on a contemporaneous basis, those facts and circumstances, what alternative accounting treatments were considered, which was accepted, and why that application was accepted and the others rejected. Further, as required by the Commission's rules, auditors should communicate alternative applications of GAAP that have been discussed with management to the company's audit committee.[112]

Given the need for a strong enforcement mechanism in order for an objectives-oriented regime to function properly, the key point for preparers and auditors is that they be able to demonstrate that they have made reasonable, good faith judgments and interpretations of the applicable accounting literature in accounting for transactions and events which affect the company's financial position, results of operations, and cash flows. Nonetheless, given the environment in which U.S. preparers and auditors function, there is a legitimate concern that evaluations about appropriateness of a company's accounting are made in light of hindsight. As such, there is a premium for preparers and auditors to demonstrate that they made reasonable, good-faith judgments at the time in accounting for transactions and events.

To reiterate the point made above, this can best be demonstrated by:

- Maintaining contemporaneous documentation that shows:
    - How the transaction or event was evaluated, including the determination of the substance of the transaction or event;
    - What body of accounting literature was applied to the transaction or event and, importantly, other alternatives that were considered, including the reasons for rejecting those alternatives;
    - The basis for concluding that the body of literature applied was appropriate; and
    - The auditor has communicated and discussed the matter with the company's audit committee.
- Including clear and transparent disclosures in the financial statements

or filings about the significant transactions and events and how those transactions were accounted for.[113]

IV. Implementation Issues

Having established the basis for the objectives-oriented regime and the necessary components, we turn our attention to the specific steps that must be taken to continue the process of implementing a more objectives-oriented regime in the U.S. We anticipate that the change should occur over time as the FASB examines specific topics in the course of carrying out its standard setting process.

As we discussed earlier in this study, the FASB has begun to use a more objectives-oriented form in issuing its standards. Additionally, a comprehensive review of the existing body of authoritative literature is underway to serve as a basis for agenda decisions and prioritizing agenda items. Additional key steps needed to implement an objectives-oriented regime in the U.S. standard-setting process include:[114]

- Address deficiencies in the conceptual framework
- Continue efforts on convergence between U.S. and international accounting standards
- Redefine the GAAP hierarchy
- Establish authoritative implementation guidance
- Increase access to authoritative literature

A. Changes to the Conceptual Framework

As noted previously, the FASB uses its conceptual framework in the process of developing accounting standards. Accordingly, having a clear, consistent conceptual framework is a necessary step in facilitating a move towards a more objectives-oriented regime. There appears to be general agreement that there is a need for the FASB to undertake a "conceptual framework improvements" project[115] as part of such a shift.[116] At issue is what the focus of this effort should be.

As the FASB's proposal acknowledges, there are, arguably, several facets of the conceptual framework which need to be addressed to facilitate the shift to a more principles-based regime. We believe that there are three key issues which the FASB should address relative to its conceptual framework as steps integral to continuing its move to an objectives-oriented regime. We see this as a "three-legged stool" involving the following efforts:

- More clearly articulate how the trade-offs among relevance, reliability, and comparability should be made,
- Eliminate the inconsistencies between the discussion of the earnings process (found in SFAC No. 5) and the definition of the elements of the financial statements (found in SFAC No. 6), and

- Establish a paradigm for selecting from among possible measurement attributes.

As observed previously, the FASB's conceptual framework currently contains an acknowledgment of the need to make trade-offs among the qualitative characteristics of relevance, reliability, and comparability. Unfortunately, as currently constructed, the framework does not provide a useful structure or guide as to how these trade-offs should be made. We recognize that the determination of the proper trade-off is a key part of the Board's responsibility in establishing accounting standards. If the basis for making the trade-off were more clearly articulated, it would provide both the Board and the profession with a clearer roadmap to understand the spirit as well as the letter of a new standard. Doing so would necessitate a change, primarily to SFAC No. 2.

The asset/liability view is fundamental to the FASB's ability to draw upon the conceptual framework in its standard setting efforts. Unfortunately, the asset/liability view and the historical notion of an "earnings process" for recognition of revenue are not completely consistent.[117] Since we believe that the FASB should maintain the asset/liability view in continuing its move to an objectives-oriented standard setting regime, we also believe that the FASB should eliminate the inconsistency by removing the need to assess the earnings process in the determination of revenue recognition. Doing so would likely involve a change primarily to SFAC No. 5. We recognize that this also may mean that the FASB will need to clarify some aspects of its definitions of the elements of financial statements resulting in a modification to SFAC No. 6.

The third major leg of the stool is the need to provide guidance on the determination of the appropriate measurement attribute. As the FASB and others acknowledge, financial reporting currently is based on a "mixed attribute" model.[118] In some instances, historical cost (or amortized cost) is used. In other instances, fair value is used. In other instances, lower of cost or market is used. Beyond that, of course, is the added confusion about when adjustments to carrying amounts are recognized in earnings. We believe that the FASB's continuing shift to an objectives-oriented regime should be greatly enhanced by an articulation of "concepts" for the use of various measurement attributes since measurement is a key element of any accounting standard.[119] Doing so would necessitate significant modifications to SFAC No. 5 and, possibly, SFAC No. 7 as well.

We believe that many projects currently on the FASB's agenda can form the basis for much of the work that should be done on the conceptual framework. For example, the FASB's revenue recognition project could form the basis for eliminating the inconsistencies between SFAC Nos. 5 and 6 on revenue recognition.[120] Likewise, the current project on liabilities and equity will address some of the questions about definitions of elements of the financial statements such that work on this project could form much of the basis for needed clarification to the definition of the elements.[121] Finally, the current projects on measuring financial instruments at fair value, measurement, and financial performance could serve as the basis for needed clarity as to the application of appropriate measurement attributes.[122]

B. Continued Efforts on Convergence

As discussed earlier, we see the FASB's shift to a more objectives-oriented regime as an integral part of its stated intentions to seek greater convergence between U.S. and international standards.[123] Both the FASB and the IASB have stated an intention to seek greater convergence of U.S. and international accounting standards. Furthermore, the SEC has endorsed this initiative.[124] In working towards convergence, the Boards have established a "short-term" working plan and a long-term plan. In its short-term working plan, the Boards have identified topics where convergence issues might be addressed quickly. For some of these matters, the FASB has been charged with the "lead" responsibility in developing or achieving a converged, high-quality solution; whereas for other items, it is the IASB that is charged with that responsibility.[125] The two Boards have targeted December 31, 2003 to achieve most, if not all, of the items on the short-term convergence list.[126]

Additionally, the two Boards have a long-term convergence strategy which will involve joint efforts on many of the Boards' current agenda projects[127] as well as an international convergence research project whereby the FASB staff can:

- **Identify all existing differences between US GAAP and IFRS**. Once identified and listed, the listing of differences will be continuously monitored and updated as new differences arise and existing differences are resolved.
- **Categorize differences based upon the most effective strategy for resolving them**. The FASB staff has identified three possible strategies for resolving differences between U.S. GAAP and IFRS: the difference (a) is expected to be resolved within the short-term convergence project, (b) is expected to be resolved within another major agenda project currently on the agenda of one or both Boards, or (c) is part of an issue that requires comprehensive reconsideration by one or both Boards. Additional strategies may be identified as work progresses.
- **Provide input to the Board's agenda setting process as needed to further the goal of convergence**. At the joint meeting of the FASB and IASB on September 18, 2002, the Boards agreed to coordinate their agendas when possible. The research project will provide the FASB with the necessary information about the effect of current and future agenda projects on convergence to enable the FASB to make informed agenda decisions that will ultimately lead to greater compatibility between US GAAP and IFRS.[128]

We believe that a continuing shift by the FASB towards a more objectives-oriented regime should facilitate the convergence process.[129] Since the convergence project will require both Boards to seek a high-quality solution to the accounting issues addressed within an objectives-oriented regime, we believe that much of the transition towards a more objectives-oriented regime could occur along with convergence efforts. In light of the 2005 deadline created by the impending adoption of IFRS within the European Community,[130] we expect that the Boards will work most intensely through

2004 and, possibly, into 2005 in an effort to achieve a significantly improved degree of convergence.

As item (3) above indicates, the determination of the Boards' respective agendas will be a part of this process. This will include prioritizing agenda items as well as adding new items to the agenda. As the standard setters move forward, the decisions of what items to add to the agenda and their relative priority will be of crucial importance in setting the pace for a shift to a more objectives-oriented regime.[131]

C. Redefine GAAP Hierarchy

The third step in the process of implementing a more objectives-oriented regime in U.S. financial reporting is a realignment of the GAAP hierarchy. The current GAAP hierarchy is organized as follows:[132]

Authoritative literature:

Level A - FASB's Statements of Financial Accounting Standards and Interpretations, APB Opinions, and ARBs

Level B - FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides and Statements of Position

Level C - EITF Consensuses and AICPA Practice Bulletins

Level D - AICPA accounting interpretations, FASB staff Q&As, and industry practice

Other literature:

SFACs, AICPA Issues Papers, IASs, textbooks, articles in professional journals.

As is evident from reviewing the existing GAAP hierarchy, industry practice is placed above the FASB's conceptual framework. The reason for this, of course, is that the conceptual framework, as currently constructed, is intended primarily to aid the FASB in its deliberations.[133] However, when the FASB completes its efforts to improve the conceptual framework, that body of literature should serve not only as a guide for the FASB in its subsequent deliberations, but also as a guide for accounting professionals as they attempt to resolve difficult issues in practice for which there is not clear guidance in the literature. The direct use of the conceptual framework by preparers and auditors to complement standards should permit standard setters to draft more succinct standards than they otherwise could.

Because of that, we would envision a change in the GAAP hierarchy at that point such that it appeared more along the lines of the following:

Authoritative literature:[134]

- FASB conceptual framework documents

- FASB standards (including SFASs, Interpretations, APB Opinions, ARBs)
- EITF consensuses (see following discussion about the need for interpretive guidance) and FSPs

Non-authoritative literature:

- These could include industry group positions, and positions of knowledgeable professional organizations or entities.

Clearly, such a change would dramatically alter the current professional thinking about the importance of the conceptual framework relative to other documents in the literature. Furthermore, it would, no doubt, require a change in the educational focus of the accounting profession (both at academic institutions and in professional organizations and other continuing professional education activities). Such a shift in the hierarchy, however, would be a necessary part of the shift in behavior (described earlier) which is needed among preparers and auditors to aid the FASB's shift to a more objectives-oriented regime.

D. Establishing Implementation Guidance

One of the key issues to be addressed in an objectives-oriented regime is who should provide implementation guidance subsequent to the issuance of a standard. As is the case currently, there will inevitably be questions that arise as accounting professionals attempt to apply the standards to specific fact patterns. This guidance will likely be developed in two different, yet important ways: (1) formal guidance and (2) informal guidance. This distinction is important, not only in characterizing the way the guidance is likely to be developed, but also in characterizing its authoritativeness.[135]

i. Formal Guidance

Consistent with our previous discussion on a revised GAAP hierarchy, we believe that there will continue to be a need for a "body of experts" to address and resolve certain implementation questions. In the U.S., that body has, since 1984, been the EITF. We believe that such a body should continue to function to address certain implementation questions that arise.[136] However, the manner in which it functions and the number of issues that it undertakes should be carefully examined.

Since its inception in 1984, the EITF has examined 434 issues[137] or approximately 24 issues per year, on average. A key question is whether, going forward, that number is about the right amount, too many, or too few. According to IASB Chairman, Sir David Tweedie, in an principles-based regime, a body such as the EITF should be addressing far fewer issues per year than the EITF has historically.[138] We agree. Under an objectives-oriented regime, the EITF would need to operate differently than it has under a rules-based regime.

Under a rules-based regime, the role of the EITF has been to provide detailed guidance on a myriad of questions that arose in practice. Often, this detailed guidance has included bright-line tests consistent with a rules-

based regime.[139] It can be argued that the EITF has functioned properly for a rules-based regime by addressing many detailed implementation issues and providing detailed guidance concerning those issues.

Under an objectives-oriented regime, however, the role of the EITF would need to change.[140] In particular, the EITF would more often need to reject the plea from accounting professionals to provide detailed guidance on many of the issues forwarded to it for consideration.[141] Additionally, the guidance that the EITF does provide would need to be consistent with an objectives-oriented approach and, thus, it would need to avoid use of bright-line tests and other telltale signs of a rules-based regime.[142]

In addition, in order to function consistently with the objectives-oriented regime, the standard setter must exercise greater control over the activities of the EITF.[143] Consistent with that, the FASB has recently announced several key changes to the operating processes of the EITF. In particular:

1. Two members of the FASB now serve on the EITF's agenda committee. This provides much greater input from the standard setter in deciding which issues should and, just as importantly, which issues should not be addressed by the EITF;

2. The FASB must ratify EITF conclusions before they become authoritative. This creates a more formalized structure to the task of providing implementation guidance relating to current authoritative standards;[144] and

3. Increased diversity of experience represented among the task force members. Beginning in January 2003, the EITF includes a representative from the investor community.[145]

ii. Informal Guidance

As noted above, as the EITF continues to function consistent with an objectives-oriented regime, it likely will be addressing fewer issues. It is unlikely, however, that there will be a commensurate reduction in the demand for implementation guidance among accounting professionals. As a consequence, there could be an increase in the demand for informal guidance.

There are several possible sources of such informal implementation guidance. These include the major accounting firms (either acting individually or collectively), professional organizations (examples include organizations such as the AICPA, Financial Executives International ("FEI"), Institute of Management Accountants ("IMA")), industry trade groups, and the academic community (primarily through publications in professional and academic journals). Furthermore, the staff of the SEC will continue to have a role in this process.

We do not envisage that these activities should cease under an objectives-oriented regime. Indeed, it is likely that some or all of these efforts will be extremely useful in enhancing comparability among reporting entities (particularly among entities which are clients of the same accounting firm).

The key issue, though, is: what level of authoritativeness should the guidance provided by these entities and organizations have?

As our previous discussion on a revised GAAP hierarchy indicates, we see the authoritative literature to be the domain of the standard setter (and, if necessary, the SEC). Other guidance should be relegated to the "non-authoritative" category of the GAAP hierarchy.

This is, of course, the current status of many of the entities and organizations included in the list above (e.g., major accounting firms' publications, FEI, IMA, industry trade groups, and the academic community). However, for one organization in particular-the AICPA-this would constitute a major change (and downgrading) in the authoritativeness of its publications.

Under an objectives-oriented regime, there cannot be a proliferation of standard setters. To allow such a proliferation invites a shift back to a more rules-based regime. Indeed, it can be argued that many of the exceptions found in today's standards exist because of the need to accommodate specialized industry practices found in AICPA Industry Guides and Statements of Position.

While we do not deny that the AICPA has experience to draw upon which can be very useful in addressing implementation questions which might arise in an objectives-oriented environment, we do not believe that one professional organization or industry trade group should receive primacy (in terms of the authoritativeness of its publications) over any other provider of informal implementation guidance.

E. Increasing Access to Authoritative Literature

While the amount of detailed guidance should be less under an objectives-oriented regime than under a rules-based regime, there would continue to be new standards and authoritative implementation guidance provided by the standard setter. One of the concerns and sources of frustration that accounting professionals have expressed is the lack of a single, searchable database containing all of the authoritative guidance.[146]

We believe that with the technological capabilities currently available, such a database should be more readily available to accounting professionals.[147] The database should include all authoritative literature and should be easily searchable. If such a resource were readily available, accounting professionals would have greater confidence that all of the pertinent literature on a given topic had been consulted when an accounting professional was attempting to resolve a difficult accounting question. Such a database also should be useful to financial statement users seeking to better understand the meaning of financial statements. There appears to be general agreement among standard setters, accounting professionals, and other key constituents that such a resource is needed.[148] We believe that it is reasonable and appropriate that the FASB should have the responsibility for developing and maintaining the resource.[149]

Assuming that it is reasonable to ask the standard setters to assume this responsibility, the key question is whether this resource should be freely

available to the public or should be made available on a subscription or cost-per-access basis. According to the Act, the FASB is to be funded by fees charged to SEC registrants.[150] Given this, there should be no financial need, once the funding provided for under the Act is in place, for the FASB to charge for access to its materials. As such, we believe that the long-run goal should be for the FASB's documents to be freely available. The costs of providing such documents could appropriately be covered by the funding mechanism provided for in the Act.

V. Economic and Policy Analysis

It is vital to the capital markets that investors receive financial information which clearly and transparently portrays companies' financial position, results of operations, and cash flows and which provides information useful to investment decisions. As described in the previous sections of this study, we believe that there are significant benefits to a continuing movement by the FASB towards an objectives-oriented approach to standard setting. Up to this point, we have examined the current situation and we have identified the steps to be taken to continue the process of implementing objectives-oriented standard setting, which the FASB already has begun. Indeed, critical to assessing the costs and benefits of a movement to objectives-oriented standard setting is an awareness that: (1) only some standards within current U.S. GAAP can properly be described as rules-based and (2) the FASB currently is in the process of implementing many of the changes recommended earlier.

In this section we present economic and policy analyses of the various trade-offs inherent in choosing one standard setting approach over another. While we have already laid out the primary findings of this study in Section I, here we provide a more extended discussion of the analytical underpinnings of those findings. The primary issues that affect the economic analysis of a movement to a more objectives-oriented standard setting regime in the U.S. are:[151]

- Improved accessibility to and meaningfulness of financial information for investors;
- Better alignment of professional incentives with investors' interests;
- Increased informativeness of financial statements under certain conditions;
- Enhanced quality, consistency, and timeliness of standard setting;
- A vehicle to facilitate convergence with international standards;
- Cost of accounting services;
- Litigation uncertainty;
- Comparability issues;
- Transition costs.

As we have discussed in this study, we believe that the benefits of continuing the movement to objectives-oriented standard setting justify the related costs.

A. Improved Accessibility To and Meaningfulness of Financial Information for Investors

Business transactions have become more and more complex. As a consequence, there is a concern among some that financial statements are becoming ever more complicated and difficult to understand. As former SEC Commissioner Stephen M. H. Wallman noted: "Without spending literally hours studying the financials, the notes to the financials, the management discussion and analysis, it's increasingly impossible to analyze a company."[152] This complexity of transactions-and the resulting complexity of the financial statements-renders it difficult for investors to understand financial reporting without carefully studying the information and the related standards on which the accounting is based. As the FASB has stated in its conceptual framework:

> The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.[153]

Rules-based accounting standards exacerbate the problems created by the complexity of business transactions. Given the complexity inherent in a rules-based standard, the investment in expertise required to perform a comprehensive analysis of the company's financial position, results of operations, and cash flows is typically prohibitive for all except a small coterie of professionals. Yet, the amounts reported in a company's financial statements are meaningless if an investor is not capable of comprehending the standards upon which they are based.[154] Moreover, rules-based accounting standards themselves drive much of the transactional complexity, as financial engineers structure transactions in an effort to produce desired accounting results. This "game" becomes ever more complex, as standard setters attempt to fill loopholes and financial engineers find ways around them. And, with each round, the demand for implementation guidance increases, resulting in a vicious cycle of ever-increasing complexity.

In contrast, under an objectives-oriented system, the cost to investors and analysts of comprehending the standards themselves should be much lower. Indeed, a reader ought to be able to obtain a reasoned conceptual understanding of the meaning of reported numbers by studying the stated objective of the pertinent standard, since-under an objectives-oriented regime-the objective provides an understanding to the user concerning how the standard is constructed and to be applied. Moreover, the full text of each standard is apt to be much easier to understand than under a rules-based regime. As a consequence, under an objectives-oriented regime, ideally, the accounting standards should serve not only as an implementation framework for the accountants, but as an interpretive guide to both investors and analysts, rendering financial reporting both more accessible and more meaningful to investors. Furthermore, under an objectives-oriented regime, much of the transactional complexity should disappear, since financial engineering to evade the objectives of a standard

would be lessened because the standard would more closely align with the stated objective.

Just as objectives-oriented accounting standards should serve as an interpretive guide to investors and analysts, so too should they serve external auditors and corporate management charged with implementing accounting standards as well as audit committees and boards of directors in their capacity of providing oversight of management. Put simply, objectives-oriented accounting standards should make it easier to ask the right questions. In contrast, when these parties are attempting to probe in matters covered by rules-based standards-fraught with exceptions and exceptions-to-the-exceptions-accounting treatments are more likely to lack a grounding in the underlying economic substance of an arrangement because the accounting question becomes one of whether specific features do or do not exist rather than about the overall substance of the arrangement. In these circumstances, gauging the reasonableness of competing interpretations of the accounting literature becomes much more challenging, rendering proper oversight of accounting decisions more difficult.[155]

B. Better Alignment of Professional Incentives and Mindset with Investors' Interests

One of the most compelling economic arguments for an objectives-oriented regime is that it holds management directly responsible for capturing the economic substance of transactions and events within the financial reporting of the company. Correspondingly, it also holds auditors responsible for reporting whether management has fulfilled that responsibility. Collectively, to fulfill their respective responsibilities under such a regime, preparers and auditors must focus on the quality of the accounting information in terms of fulfilling the objectives served by each accounting standard. In this manner, objectives-oriented accounting standards demand accountability-and corresponding exposure to liability-on the part of management and accountants for providing information that is representationally faithful to the economic substance of the underlying transactions and events that affect the company's performance and financial position. This arrangement should serve to better align the incentives of accounting professionals with those of investors.

Moreover, this responsibility-i.e., to implement the stated objective of an accounting standard-may subtly, but fundamentally, alter the nature of accounting work. As noted above, accountants would be required to focus on the economic substance of transactions and other covered events and exercise their judgment in a manner that maximizes the information conveyed to the market rather than directing their judgments on the question of which standard within the myriad of exceptions and contradictions should be applied. This could constitute a significant change in how many accountants think about and approach their work.

In contrast, under a rules-based regime, accountants tend to develop a "check-list" mentality. That is, rather than take responsibility for determining whether financial reporting fully reflects and fulfills the objectives embodied in accounting standards, accountants may mechanically apply the rules and merely check that the treatment is not prohibited by GAAP or meets the "bright-line" standards within GAAP. One

unintended consequence of this check-list approach is that the rules themselves come to serve as a roadmap in structuring transactions that appear sanctioned by the rules, but which are, in fact, misleading.[156] To the financial engineer seeking to structure transactions that transform debt into equity, shift revenue recognition, create an operating rather than a capital lease, or otherwise obscure the financial condition of a reporting company, the rules do not constrain so much as merely constitute challenging puzzles. Human ingenuity is such that accounting standards can never be written at a level of detail sufficient to preclude financial engineering designed to hide more than it reveals. While standard-setters might move to fill accounting loopholes discovered by financial engineers, they are apt to always be a few steps behind. Indeed, excessively detailed accounting standards not only constitute a guideline to fraud, but a ready-made set of defenses, providing management and accountants with the colorable claim that they followed the rules, even while they may have intended to mislead.

Indeed, in its very precision, a rules-based regime may well give a false sense of accuracy. While the rules may be precise-with bright-line tests on the finest minutia of financial reporting-the financial reporting itself remains subject to manipulation either through interpretation of the accounting evidence itself or through structuring transactions within the standards that are nonetheless designed to yield misleading accounting results as noted above. The latter practice has been referred to by some as "financial engineering" and, itself constitutes an added cost of the rules-based approach.[157]

These drawbacks-and the shades of "gray" associated with them-permeate accounting under a rules-based regime, and are not limited to the abuses of those with fraudulent intent. As Sir David Tweedie, IASB Chairman, said in his testimony before the Committee on Banking, Housing and Urban Affairs of the U.S. Senate:

> [A] body of detailed guidance . . . encourages a rule-book mentality of "where does it say I can't do this?" . . . [It] helps those who are intent on finding ways around standards more than it helps those seeking to apply standards in a way that gives useful information. . . . The emphasis tends to be on compliance with the letter of the rule rather than on the spirit of the accounting standard.[158]

C. Increased Informativeness of Financial Statements Under Certain Conditions

If the professional judgment of preparers and auditors is exercised in the interest of investors, objectives-oriented accounting standards have the potential to increase the informativeness[159] and comparability of financial reporting as compared with rules-based standards. Of course, the question is: will management and accountants tend to exercise that judgment appropriately and honestly and thereby, in fact, increase the informativeness of the financial information provided to investors? The answer to this question depends, in part, on the presence of effective enforcement.[160]

It is a common misperception that an objectives-oriented regime must

operate in an environment of more relaxed enforcement, with correspondingly greater trust placed in those producing the financial information. In fact, just the opposite is the case. While an objectives-oriented regime does place responsibility on the shoulders of management and accountants, its efficacy depends on rigorous enforcement.[161] Effective enforcement renders it both more expensive and risky for dishonest management to attempt to send false signals to the market through the fraudulent manipulation of their financial information. In turn, by making it expensive for mal-intentioned management to mislead, honest managements are given the opportunity and incentive to distinguish their companies from the market's "lemons."[162] In this manner, effective enforcement may encourage honest companies to invest in and take full advantage of the structure offered by objectives-oriented accounting standards to convey more useful information to the market and thereby lower their cost of capital.[163]

Other things being equal, the increase in informativeness of financial statements due to the adoption of objectives-oriented accounting standards-combined with an effective enforcement regime-should leave investors better able to glean from financial statements the underlying economic reality associated with each company. This should permit companies with good economic stories to better distinguish themselves from those attempting to veil reality. In turn, this should serve to decrease uncertainty and thereby lower the average cost of capital.

D. Enhanced Quality, Consistency, and Timeliness of Standard Setting

Globalization, technological change, financial innovation and regulatory competition are generating a continuous stream of challenges to both regulators and the private sector in their efforts to maintain an effective financial reporting system. Due to the faster pace of change driven by these factors, timeliness in the development of accounting standards has grown in importance.

Objectives-oriented standard setting better fits this faster paced environment for two reasons. First, standard setters should be able to move faster to address emerging practice issues under an objectives-oriented regime.[164] It is easier to come to an agreement on a principle than on a highly detailed rule, even if the principle is substantive and relatively specific in nature. It also takes more time to develop and provide extensive implementation guidance on a wide variety of hypothetical scenarios, as required by the rules-based approach.[165]

Second, by its very nature, a standard setting body cannot respond as quickly to changes in the environment as can the professionals directly involved in the marketplace. Because, when properly constructed, objectives-oriented accounting standards are solidly based on a conceptual framework, yet cabined by the specific, substantive objectives embodied in each standard, they provide for a framework within which the application of professional judgment can be exercised. As such, managers and accountants should be able to draw upon the objectives of the standard so that their accounting decisions better capture economic reality in response to market developments. This should render objectives-oriented accounting

standards more durable once they are in place than are rules-based standards. The latter tend to be in greater need of constant tinkering by standard setters[166] to reflect changes in the environment than do objectives-oriented standards.[167]

Objectives-oriented accounting standards not only render the standard setting process more timely, but also should improve the quality and consistency of its product. The objectives of financial reporting are to provide information that is useful to investors and creditors-both current and potential-in making rational investment and credit decisions.[168] As such, the information should help these parties make an assessment of the amount, timing and uncertainty of future cash flows that may derive from investment or credit decisions.[169] Stated differently, the focus of the financial reporting process is (or should be) on the information needs of external users of the financial information. Under an objectives-oriented regime, a greater number of users should be able to grasp the principles at issue and, thus, they are likely to take the trouble to do so and to participate in the standard setting process. As a consequence, the resulting standards should be more likely to meet the information needs of users.

In contrast, a rules-based regime requires respondents to possess a much more detailed understanding of the intricacies of complex accounting rules and issues if they are to participate meaningfully in the standard setting process. As a consequence, a rules-based regime creates a significant barrier to entry into the accounting debate. The lowering of the hurdle for meaningful participation in the standard setting process that results from the adoption of an objectives-oriented approach should permit the participation of users who might otherwise have been excluded from the process and who may raise issues that otherwise might have been missed.

Preparers and auditors tend to seek additional detail and implementation guidance. They also tend to desire bright-lines to provide a roadmap for accounting for the transactions and events.[170] Furthermore, preparers often could lobby the FASB to seek exceptions to the scope of standards to avoid volatility of earnings that might result from the application of the standards.[171] As a consequence, a rules-based standards regime tends to be self-reinforcing-with ever increasing complexity serving narrow interests, while simultaneously increasing the barriers to meaningful participation by the user community. While the preparers and auditors who participate in the process are generally well-intentioned-indeed, their motives are typically beyond question-and while their contributions to the process are substantial and much needed, they simply cannot and do not fully reflect the interests of the user community.

For similar (and additional) reasons, the barring of exceptions under an objectives-oriented approach also enhances the quality of standards. As noted previously, by their very nature, exceptions do not fall within an underlying principle that would otherwise demarcate an objectives-oriented standard. Thus, allowing exceptions permits standard setters to take an undisciplined and fundamentally inconsistent approach to establishing standards. Additionally, the existence of numerous exceptions indicates that the class of transactions to which the standard applies has been too broadly defined. This is harmful in two ways.

First, it may render standard setters more subject to untoward influences. A rules-based approach that embraces the use of exceptions makes it easier for a narrow set of interests to be reflected in the standards at the expense of the more general interest of the user community. Exceptions result, primarily, from the demands of preparers and auditors. Often at the heart of the cry for exceptions by preparers is the concern that the principle upon which the standard is based will result in increased earnings volatility. In an effort to avoid the volatility in reported earnings that might result from the application of the standard, preparers may ask for (and receive) exceptions to the standard.[172] While preparers often argue that the exception is needed to avoid the earnings volatility that would result from the application of the standard, the real question for the standard setter is: which depiction is more representationally faithful to the underlying economic reality of the company? If the company's economic activities are subject to volatility, then providing scope exceptions which allow the company to avoid the portrayal of that volatility in earnings is not representationally faithful and, thus, does not provide information that meets the FASB's objectives of being decision useful to investors.[173]

Second, a proliferation of exceptions typically leads to fundamental inconsistencies in accounting treatments. As noted above, exceptions are, by their very nature, antithetical to principles. And while there may be rare occasions where the cost-benefit analysis is such that it makes sense to include exceptions-such as when there is an extant and well-developed body of literature covering a well-defined subset of the applications-the cost associated with incorporating such fundamental inconsistency into the standards regime can be high. This cost includes not only the extra complexity thereby introduced, but also the incentive that the presence of exceptions creates for preparers to engage in financial engineering to bias interpretations of accounting evidence for purposes of evading or enjoying certain accounting treatments and, of course, to expend resources pressuring standard setters to allow unprincipled exceptions to be included in the standards.

While the users of financial statements have a fundamental interest in accounting standard setting, that interest also tends to be general and diffuse. In stark contrast, the interests of preparers, auditors and other professionals involved in the production of financial statements are direct, intense and narrow. As a consequence, the general interests of the many may be under-represented in deliberative processes and sacrificed to the benefit of the intense interests of the few, as the latter have a stronger incentive to participate actively in the process. While this is true under any standard setting regime, a rules-based approach to standard setting tends to re-inforce this exclusion of the interests of the user community. Unprincipled treatment of special interests is more readily disguised when drafting complicated rules, or providing for scope exceptions, than when formulating more principles-based accounting objectives.

E. Providing a Vehicle for Convergence with International Accounting Standards

Institutional efforts to achieve global accounting standardization have recently gained momentum. In a Memorandum of Understanding, released in October 2002, the FASB and the IASB agreed to work together toward convergence of global accounting standards.[174] In addition, both Boards

have entered into a joint short-term convergence project.

Continuing to move towards objectives-oriented standard setting in the U.S. would increase the speed and likelihood of convergence.[175] By 2005, all listed EU, Australian, and Russian companies will be using IFRS[176] to report financial results in their home markets. Agreement on principles, even if substantive in nature and relatively specific in content, is easier than agreement on highly detailed rules. Thus, reaching the international consensus necessary for convergence would be easier and proceed at a faster pace if the converging systems both take an objectives-oriented approach.

Global accounting standardization would produce a myriad of benefits including:

- **Greater comparability for investors across firms and industries globally**-The general acceptance of global accounting standards would lower the cost to investors of comparing firms and industries globally. Such global standardization places investors in a better position to diversify globally at lower expense, which can lead to greater expected return at a given level of risk, or, alternatively, less risk at any given level of expected return;

- **Lower listing costs for companies with multiple listings**-Currently, the U.S. requires foreign private issuers listing in the U.S. to reconcile their accounting to U.S. GAAP. Similar requirements exist in other markets as well. This results in two sets of financial statements. A global accounting standard would eliminate this duplicative cost for such companies;

- **Greater competition among exchanges**-With more transparent and comparable information available, barriers to entry from one market to another would be lowered, thereby creating greater competition among exchanges;

- **Improved resource allocation and capital formation globally**-Since markets would have greater access to comparable information, the markets would be able to more efficiently allocate the scarce resources within the marketplace among the investment alternatives;

- **Lower cost of capital globally**-Companies should experience a lower cost of capital since companies should be able to access capital in different markets without having to maintain records on different bases to fulfill the reporting requirements in each marketplace; and,

- **A higher global economic growth rate**-Improved market efficiency should result in share prices that better reflect the underlying economic reality. In turn, this should lead to a more efficient allocation of capital to those companies with the best prospects. This increase in allocative efficiency should result in increased economic growth across the globe. In addition, lower cost of capital should lead to higher investment rates, similarly stimulating economic growth.

F. Cost of Accounting Services

The use of objectives-oriented accounting standards may impact the cost of accounting services due to at least four factors.

First, the time and cost to both preparers and auditors of dealing with outside agents, including the PCAOB and company audit committees, may be increased by the reduction in implementation guidance associated with an objectives-oriented approach. As a consequence of the more modest amount of guidance, preparers, auditors, and regulators will sometimes lack a common understanding and approach to particular applications. This may serve to not only increase cost associated with enforcement defense and restatements, but also, as FASB member Katherine Schipper notes, cost associated with "day-to-day interactions with the SEC staff over periodic filings and registration statements."[177] On the other hand, under a rules-based regime, there often is a need to seek advice from experts on the proper application of a detailed rule. Thus, just as a rules-based regime creates costs to financially engineer a desired accounting result, it also can create costs to interpret the complex rules in determining whether, indeed, the desired accounting result has been achieved. In sum, it is difficult to estimate the net influence of this factor on the cost of accounting services.

Second, to the extent that insurance carriers believe that accountants and auditors (and, for that matter, management) are exposed to increased potential liability due to an objectives-oriented approach, they may increase professional insurance rates. To some extent, these increases in costs are apt to be passed on to clients.

Third, the shift in professional judgment required by an objectives-oriented approach places a premium on accountants with an ability to understand the objectives and evaluate and interpret the underlying economic reality. If there is a scarcity of appropriate human resources, the increased demand for this type of accounting talent may result in increased salaries for accounting professionals. This increase in costs to the firms to obtain the needed accounting talent would result in an increase in the firm's billing rates.

Fourth, to the extent that implementation details are no longer provided by standard setters, they may still present a variety of questions that must be answered by practitioners in the field. In answering these many questions, practitioners would have to expend resources. This is apt to increase the cost of accounting services.

G. Litigation Uncertainty

Some have argued that an increased reliance on the capabilities and judgment of preparers and auditors inherent in principles-based accounting standards may increase the likelihood of retrospective disagreements on accounting treatments. In turn, it is argued that this will result in an increase for both companies and auditors in litigation with both regulators and the plaintiffs' bar.[178]

In reality, however, like other arguments regarding the cost of objectives-oriented standard setting, this argument seems to be predicated in part on

confusion between principles-only and, what we have defined as objectives-oriented (principles-based) standards. To be sure, with principles-only standards, this risk would seem to be quite high and the related costs significant. In contrast, with objectives-oriented standards, when properly constructed, the objectives are clearly stated and there is structure and implementation guidance to cabin the judgment of the professionals, such that that judgment is not exercised in a vacuum or within a broad spectrum of possibilities. Thus, the range of responses in which professional judgment can fall is tightly bounded, thus significantly mitigating this risk.[179]

Since objectives-oriented accounting standards-in conjunction with an effective enforcement regime-do serve to better align the incentives of preparers and auditors with those of investors, with a resultant increase in the informativeness of financial statements, there should be a reduction in meritorious cases brought against preparers and auditors and, most likely, a consequent overall reduction in litigation costs and damages under an objectives-oriented approach. If preparers and auditors maintain contemporaneous documentation that demonstrates that they properly determined the substance of a covered transaction or event, applied the proper body of literature to it, had a sound basis for their conclusions-particularly those involving the exercise of judgment-and ensured through disclosure that their method was transparent, their exposure to litigation may be relatively minimal.

H. Comparability Issues

We believe that, overall, the movement to an objectives-oriented approach to standard setting should result in increased comparability in terms of economic substance. Indeed, the comparability arguably associated with a rules-based regime is often illusory.[180] This is for four reasons.

First, complex financial engineering stimulated by and designed to circumvent a rules-based regime reduces transparency and, correspondingly, may reduce genuine comparability of underlying economic circumstances.

Second, a uniformity of accounting treatment may only result in a superficial kind of comparability if guidance is inappropriately rigid and thereby forces unlike arrangements into the same accounting treatment.

Third, the clustering of underlying transactions on either side of bright-line rules associated with a rules-based regime results in different accounting treatment being given to arrangements that are fundamentally the same.

Fourth, it should be noted, of course, that under an objectives-oriented regime, comparability can be achieved as long as there is transparency of method used through disclosure, albeit not necessarily at the same cost to the investor or analyst as under a rules-based regime.[181]

That being said, there may be some instances in which objectives-oriented accounting standards result in the loss of some degree in the precision of comparability of financial statements across firms and industries in some narrow application contexts, or at least render it more expensive to achieve

comparability.[182] That is, in certain applications, the extra guidance and greater detail provided under a rules-based regime may result in a greater uniformity.

I. Transition Costs

We believe that the transition costs would be relatively small, as the transition to an objectives-oriented approach already is underway, at least in part, and should continue on a gradual basis.

We believe that the accounting profession itself would incur only de minimis transitional costs in the immediate term, since we expect the FASB to continue to implement these recommendations on a gradual basis through its continuing standard-setting efforts. Going forward, however, as objectives-oriented accounting standards are adopted, to the extent that a different type of professional judgment is called for on the part of practitioners, accounting firms will find that they may have to further strengthen their training, quality control and oversight mechanisms for all accounting personnel within the firm. Moreover, there may be additional efforts needed internally on training and education to accommodate the heightened professional and intellectual demands that will be placed on practitioners. On the other hand, this extra cost may be offset by the reduction in training associated with the elimination of excessively detailed standards associated with a rules-based approach.

The FASB itself may face some additional pressure on the use of its internal (and limited) resources as it attempts to address issues raised in the conceptual framework which are in need of maintenance in light of the adoption of objectives-oriented accounting standards.

A final transitional cost would be in terms of the cost of comparability across time. That is, as objectives-oriented accounting standards are adopted, they will inevitably result in substantive accounting changes.[183] These changes may make precise comparability across time more difficult in the transition period. If the FASB requires retroactive application to ensure consistency and comparability, this will impose additional costs on preparers.

VI. Conclusion

As noted at the outset of this study, the Act mandated that the Securities and Exchange Commission conduct a study on the adoption by the U.S. of principles-based accounting standards.[184] This study, intended to fulfill that mandate, concludes that the adoption of objectives-oriented principles-based accounting standards in the U.S. would be consistent with the vision of reform that was the basis for the Sarbanes-Oxley Act. The following table outlines the key steps involved in moving the U.S. standard setting process to a more objectives-oriented approach:

Action Items	Current Status	Time Horizon
Conceptual framework improvements	FASB currently evaluating most efficient approach[a]	Medium Term

project		
Move towards objectives-oriented form of standards	Prior to SFAS No. 141, there was some inconsistency in use of objectives-oriented form (e.g., no reference to how standard related to conceptual framework). Recent standards (e.g., SFAS No. 141 and following) have, more consistently, included elements of objectives-oriented form	Immediate
Comprehensive review of current standards to identify and address those that are rules-based	SFAS No. 141 superseded APB Opinion No. 16 (rules-based); accounting for stock-based compensation added to FASB agenda on March 12, 2003; staff and Board evaluating existing standards for purposes of future agenda decisions	Underway
One standard setter[b]	AcSEC will no longer be responsible for issuing "authoritative" standards, transition plan is in place; EITF consensuses now are subject to FASB approval	Underway
Redefine GAAP hierarchy	Conceptual framework improvements project to be completed first	Medium term
Convergence	In October 2002, FASB and IASB jointly announced intention to work towards convergence of international and domestic standards. Joint or cooperative projects underway include business combinations, measuring financial performance, stock-based compensation, revenue recognition, and short-term convergence[c]	Underway, some standards expected to be issued within the next year, but effort will be long term

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1 In doing so, however, standard setters must avoid the temptation to provide too much detail (that is, avoid trying to answer virtually every possible question within the standard itself) such that the detail obscures or overrides the objective underlying the standard.

2 While we recognize that bright-line tests are intended to offer the benefits of clarity and simplicity, we believe that bright-lines can sometimes result in accounting that does not reflect the underlying economic reality of a transaction. With respect to the formulation of accounting standards, we believe that the potential benefits do not justify the cost that result from the use of bright-lines. First, and foremost, the goal of accounting is to always reflect economic reality. When bright-lines are developed, it is with the knowledge that the application of the bright-lines will capture the underlying reality most, but not all, of the time. Second, transactions engineered to meet those bright-lines result in lost transparency, comparability and accountability in the financial reporting. For these reasons, we see the cost of bright-lines as inevitably swamping any potential benefit.

3 In this study, when we state that a principles-only approach to standard setting provides insufficient structure and guidance to cabin the judgment of preparers and auditors, we are speaking from a policy perspective. That is, by

"insufficient," we mean that the standard is established at a level of specificity where there is less structure and guidance than would be optimal in terms of ensuring relevance, reliability and comparability of financial reporting. With respect to any current standard that is toward the principles-only end of the spectrum, such policy statements do not mean to imply that such standard does not provide sufficient structure and guidance for the standard to be enforceable or to hold preparers and auditors accountable.

4 The Financial Accounting Standards Board ("FASB") developed a "conceptual framework" between the mid-1970s and mid-1980s to serve as a conceptual underpinning to the standard setting process.

5 The body of literature that constitutes GAAP is extensive. Statement on Auditing Standards ("SAS") No. 69, "The Meaning of `Present Fairly in Conformity With Generally Accepted Accounting Principles'," established a "hierarchy" of the relative authoritativeness of each type of document.

a At its meeting of March 26, 2003, the FASB directed its staff to develop a proposal for a conceptual framework improvements project focusing on the selection of appropriate measurement attributes and related relevance and reliability issues.

b While there would be one standard setter (FASB), the SEC will continue in its oversight role with respect to the standard setter.

c At its meeting of March 26, 2003, the FASB established a near-term objective of using identical style and wording in the standards issued by the FASB and IASB on joint projects.

1 The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 2002.

2 As used here, penalties is meant in a broad economic sense rather than a strict legal sense. Penalties include not only the consequences of legal action against the parties, but also, investigation and disciplinary action by the PCAOB, the SEC's Division of Enforcement, audit committee oversight over financial reporting, civil litigation, and harm to reputational capital.

3 The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 2002. In pertinent part, Section 108(d) states: "The Commission shall conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system."

4 See Section II infra. for the answer to this inquiry.

5 See Section VI infra for the answer to this inquiry, provided in a chart with time horizons associated with action items related to changing from a rules-based to a principles-based financial reporting system.

6 See Sections I and, particularly, III and IV, infra., for the answer to this inquiry.

7 See Sections I and, particularly, V, infra., for the answer to this inquiry.

8 As used here, the phrase investors and creditors is intended to be consistent with its use in FASB, Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," November 1978. In particular, see ¶24 where the FASB stated that "the potential users are owners, lenders, suppliers, potential investors and creditors, employees, management, directors, customers, financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities, legislators, financial press and reporting agencies, labor unions, trade associations, business researchers, teachers and students, and the public."

9 Id., ¶32.

10 Since this study focuses on principles-based standard setting, we do not include a detailed analysis of these other changes. However, it is an important point and one we will return to in the context of our discussion about the need for enforcement.

11 In addition, from an analytical perspective, this approach serves a useful function, in that it benchmarks the opportunity cost (i.e., the economic loss from an opportunity foregone) associated with instances where U.S. standards are sub-optimal in this regard.

12 See, for example, comment letter of David Mosso, former member of the FASB.

13 Based on responses to the FASB's Proposal: Principles-Based Approach To U.S. Standard Setting as well as comments made by participants at roundtables and in other forums, it appears that many hold the view that principles-based standards means high-level standards with little, if any, operational or detailed guidance.

14 In this study, when we state that a principles-only approach to standard setting provides insufficient structure and guidance to cabin the judgment of preparers and auditors, we are speaking from a policy perspective. That is, by "insufficient," we mean that the standard is established at a level of specificity where there is less structure and guidance than would be optimal in terms of ensuring relevance, reliability and comparability of financial reporting. With respect to any current standard that is toward the principles-only end of the spectrum, such policy statements do not mean to imply that such standard does not provide sufficient structure and guidance for the standard to be enforceable or to hold preparers and auditors accountable.

15 These concerns (as well as the lack of a uniformly-understood notion of both principles-based and rules-based standards) are evident when examining the FASB's Proposal: Principles-Based Approach To U.S. Standard Setting, October 21, 2002; comments by participants at Roundtable Discussions (e.g., AAA/FASB Financial Issues Conference, December 7, 2002, FASB Roundtable Discussion, December 16, 2002; Baruch College Roundtable Discussion, February 11, 2003); respondents to the FASB's Proposal; and academic articles. Many of these comments are cited throughout this study.

16 See, for example, comment letter of James P. Hoffa, General President of International Brotherhood of Teamsters.

17 We use the modifier "actual" comparability to distinguish it from the illusory comparability that may be created under a rules-based standard. See Section I.E which provides an example of rules-based standards.

18 Comments made by Jim Harrington, PricewaterhouseCoopers, LLP, Greg Jonas, Moody's Investors Service, Elizabeth Fender, TIAA-CREF at Baruch College Roundtable on "Shifting to a Principles-Based Accounting System: Will It Improve Financial Reporting in the U.S.?" February 11, 2003.

19 With principles-only standards, there is not a sufficient structure for management and auditors to frame their judgments consistently from one application to another. With rules-based standards, management and auditors must exercise judgment in determining which of the exceptions are applicable to their specific fact pattern.

20 In fact, in a rules-based regime, the standard setter is attempting to impose its judgment on management and auditors by establishing bright-line tests which are used in place of judgment by management and auditors.

21 Koreto, Richard J. "Beresford Looks Forward," Journal of Accountancy, July 1997.

22 We do not mean to imply by this statement or any statement made in this

study that any current U.S. standard is lacking in terms of providing sufficient structure, guidance and consistency to hold preparers and auditors accountable and to be enforceable, as we do not believe that to be the case. Recognition that there is room for improvement and, in particular, the desirability of further cabining the scope for the application of professional judgment, should not be confused with a suggestion that current standards are inadequate in terms of their enforceability.

23 As we noted earlier, the word "penalties" is meant in a broad economic sense rather than a strict legal sense. Penalties include not only the consequences of legal action against the parties, but also, investigation and disciplinary action by the PCAOB, the SEC's Division of Enforcement, audit committee oversight over financial reporting, civil litigation, and harm to reputational capital.

24 We include within the body of literature referred to as IFRS the previously established standards referred to as International Accounting Standards ("IASs").

25 Effective for 2005, European companies listed on exchanges and markets within the European Community generally will be required to adopt IFRS for financial reporting purposes.

26 Many of the IASs contain a "benchmark" accounting treatment but also provide for one or more "allowed alternative" treatments, each of which is consistent with a broad principle. Under these standards, almost any interpretation is acceptable.

27 Some have argued that rules-based standards reduce the need for professional judgment in determining the proper accounting. However, because rules-based standards inevitably have inconsistencies, professional judgment is needed to determine what aspect of the literature is appropriate. This exercise in judgment will, then, lead to a multiplicity of accounting answers depending on the particular judgments made. Thus, while the nature of the judgment is different under a rules-based vs. a principles-based or objectives-oriented approach, it cannot be said that rules-based standards require less judgment than in a principles-based regime.

28 This example is based on the accounting for business combinations under APB Opinion No. 16, "Business Combinations." APB Opinion No. 16 was superseded by Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations." See, "Illustration of the Use of Optimal Scope Theory" later in this report for a further discussion of the implications of SFAS No. 141.

29 While the APB noted that it found "merit in both the purchase and pooling of interests methods of accounting for business combinations," it can be argued that there is a presumption in APB Opinion No. 16 that the purchase method is appropriate since companies had to specifically demonstrate that a combination met all of the pooling of interests criteria. Failure to do so resulted in the application of the purchase method.

30 The application of the pooling criteria could result in two combinations that were identically structured being accounting for differently. For example, one of the criteria of APB Opinion No. 16 stated that the combining companies must have been autonomous and not a subsidiary or division of another company within two years of the initiation of the combination. Therefore, two combinations could be structured in exactly the same way with one being accounted for as a pooling of interests and the other being accounted for as a purchase because one of the combining companies failed the autonomous criterion.

31 See, e.g., Hopkins, Patrick E., Richard W. Houston, and Michael F. Peters, "Purchase, Pooling, and Equity Analysts' Valuation Judgments," Accounting

Review, July 2000.

32 See, e.g., section 19(a) of the Securities Act of 1933, 15 USC 77s(a), and section 13(b)(1) of the Securities Exchange Act of 1934, 15 USC 78m(b)(1).

33 Accounting Series Release No. 4, "Administrative Policy on Financial Statements," April 25, 1938.

34 Storey, Reed K. and Sylvia Storey, The Framework of Financial Accounting Concepts and Standards, January 1998.

35 The American Institute of Accountants changed its name to the American Institute of Certified Public Accountants ("AICPA") in 1957.

36 ARB No. 43, Restatement and Revision of Accounting Research Bulletins, "Ch. 1: Introduction," June 1953, paragraph 8.

37 Special Committee on Research Program, "Report to Council of the Special Committee on Research Program," Journal of Accountancy, December 1958, p. 63.

38 APB, Statement No. 1, "Statement by the Accounting Principles Board," April 1962.

39 Accounting Series Release No. 150, "Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards," December 20, 1973.

40 The Commission recently reaffirmed its support of the FASB's standard setting efforts. See, Release No. 33-8221, "Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter," April 25, 2003.

41 We will address the issue of the authoritativeness of these statements in our discussion of Implementation Issues in Section IV.

42 FASB, Statement of Financial Accounting Concepts No. 1, "Objective of Financial Reporting by Business Enterprises," November 1978.

43 Schipper, Katherine, "Principles-Based Accounting Standards" Accounting Horizons, March 2003.

44 The FASB began including this analysis in its statements beginning with the issuance of SFAS No. 141, "Business Combinations."

45 This is an issue we will return to in our discussion of Implementation Issues.

46 The FASB has announced plans to revoke, after a transition period, AcSEC's authority to issue Statements of Position. Additionally, beginning in January 2003, the operating procedures of the EITF were changed such that EITF consensuses are now subject to FASB approval before those consensuses are deemed to be authoritative. Finally, a process was implemented such that all guidance offered by the FASB staff must first be approved by the FASB itself.

47 See, SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles," at AU §411.

48 See the subsequent discussion of implementation issues regarding changes in the role of AcSEC and the EITF.

49 Issuance of these documents by AcSEC is subject to clearance by the FASB.

50 See, AU §411.10.

51 In February 2003, the FASB staff announced that it plans to issue future application guidance through FASB Staff Positions ("FSPs"). The FASB staff will circulate a draft of a proposed FSP to Board members for their review. If

a majority of Board members do not object to the proposed FSP, it will be posted on the FASB website for comment for a period of 30 days. That exposure will allow the FASB staff and Board to consider constituent comments and concerns about the proposed FSP. At the end of the exposure period, the FASB staff will draft the final FSP. Provided that a majority of the Board members do not object, the final FSP will be issued. This new process and form of guidance is intended to allow for more timely and consistent communication about the application of FASB literature.

52 Announcements by the staff of the FASB or of the SEC are found in Appendix D to the EITF Abstracts. As such, they are typically referred to as "D-Topic" issues.

53 Previously, the AICPA staff issued "Interpretations" of APB Opinions.

54 See, e.g., comments made by participants at AAA/FASB Financial Issues Conference, December 7, 2002; FASB Roundtable Discussion, December 16, 2002; and Baruch College Roundtable Discussion, February 11, 2003.

55 SFAS Nos. 133 and 140 are examples of this "spiral" of increasing complexity born from the demand for additional guidance because of the existence of scope exceptions and/or bright-lines in the standards. For example, the FASB staff plans to issue in July 2003 an interpretation of SFAS No. 133 that involves a new "bright-line" on evaluating correlation of certain price changes to indexes.

56 The Derivatives Implementation Group ("DIG") was a task force that was created in 1998 to assist the FASB in answering questions that companies faced when they began implementing SFAS No. 133. The FASB's objective in forming the DIG was to establish a mechanism to identify and resolve significant implementation questions in advance of the implementation of SFAS No. 133 by many companies.

57 See, FASB, Accounting for Derivative Instruments and Hedging Activities as of December 10, 2001. This book contains the provisions of SFAS Nos. 133, 137, and 138 as well as the DIG Issues. Additionally, there are several issues which have been addressed by the EITF which add to this body of literature (e.g., Issue Nos. 86-26, 99-2, 00-17, 00-19) which are not included in the 800 page derivatives book. Finally, the FASB recently amended SFAS No. 133 with the issuance of SFAS No. 149.

58 Much, but not all, of that guidance is found in FASB Interpretation No. 44 and EITF Issue No. 00-23.

59 SFAS No. 140 was issued to replace the predecessor standard, SFAS No. 125. SFAS No. 125 was issued in June 1996 and it was replaced by SFAS No. 140 in September 2000.

60 It should be noted that bright-lines such as the 50% threshold for consolidation is not an explicit bright-line. However, practice often operates as though it were a bright-line.

61 AICPA, Accounting Research Bulletin No. 51, "Consolidated Financial Statements," August 1959.

62 EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions." This consensus was subsequently nullified by FASB Interpretation No. 46, "Consolidation of Variable Interest Entities," January 2003, which is effective for new structures created after January 31, 2003 and for all existing structures beginning with the first interim or annual period beginning after June 15, 2003.

63 FASB, SFAS No. 87, "Employers' Accounting for Pensions," December 1985. See, also, FASB, SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," December 1990.

64 FASB, SFAS No. 66, "Accounting for Sales of Real Estate," October 1982.

65 In addition to implementation guidance provided by the staff, the EITF provides a significant amount of detailed guidance, often with bright-lines. We will return to the activities of the EITF in the Implementation Issues section.

66 Amble, Joan Lordi and Jules M. Cassel, A Guide to Implementation of Statement 87 on Employers' Accounting for Pensions, FASB, December 1986; Revised, December 1998; Revised, September 2001. FASB Staff, Statement 87 Q&A - Impact of the Sunset Provision of the Economic Growth and Tax Relief Reconciliation Act. Amble, Joan Lordi and Jules M. Cassel, A Guide to Implementation of Statement 88 on Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, FASB, January 1988; Revised, December 1998; Revised, September 2001. Dakdduk, Kenneth E. and Jules M. Cassel, A Guide to Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits Other Than Pensions, FASB, August 1993; Revised, December 1998; Revised, September 2001.

67 Perry, Raymond E. and E. Raymond Simpson, A Guide to Implementation of Statement 109 on Accounting for Income Taxes, FASB, March 1992; Revised, December 1998; Revised, September 2001.

68 SFAS Nos. 141 and 142 were issued based on Phase I of the FASB's Business Combinations project with SFAS No. 141 addressing the accounting for the business combination and SFAS No. 142 addressing the subsequent accounting for recognized intangible assets.

69 FASB, Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," November 1978.

70 The FASB defines these terms as: Relevance is information's capacity to "make a difference" . . . To be relevant to investors, creditors, and others for investment, credit, and similar decisions, accounting information must be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations. FASB, Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," May 1980, paragraphs 46-47. Reliability, the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user, which comes through verification, that it has that representational quality. FASB, SFAC No. 2, paragraph 59. Comparability is the quality or state of having certain characteristics in common, and comparison is normally a quantitative assessment of the common characteristic. Clearly, valid comparison is possible only if the measurements used - the quantities or ratios - reliably represent the characteristic that is the subject of comparison. FASB, SFAC No. 2, paragraph 115.

71 FASB, SFAC No. 2, paragraph 42.

72 There are some who mistakenly believe that an "asset/liability" view is synonymous with saying that the balance sheet has priority over the income statement. In reality, an asset/liability view is an approach to understanding the substance of transactions and events so that the consequences of those transactions and events can be reflected in the financial statements (which includes the balance sheet, income statement, cash flow statement, and statement of equity) in a manner that is most relevant to investors. Under an asset/liability view there will be "flows" to those assets and liabilities and it is those flows which serve, in part, as the basis for determining periodic income.

73 More particularly, in SFAC No. 6, the FASB gives priority to the definitions of assets and liabilities by defining the other elements-equity, revenues, expenses, gains, losses-in terms of changes in those more fundamental

elements. SFAC No. 6 defines the elements of the financial statements as follows:

> Assets - probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
>
> Liabilities - probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
>
> Equity - the residual interest in the assets of an entity that remains after deducting its liabilities.
>
> Revenues - inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
>
> Expenses - outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
>
> Gains - increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.
>
> Losses - decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

74 These accruals and deferrals needed to "balance" have been referred to by some as "what-you-may-call-its." See, Sprouse, Robert T., "Accounting for What-You-May-Call-Its," Journal of Accountancy, October 1966.

75 The APB often adopted a revenue/expense view when issuing Opinions. See, for example, Opinion No. 8, "Accounting for the Cost of Pension Plans," November 1966 and Opinion No. 11, "Accounting for Income Taxes," December 1967.

76 See, for example, APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," October 1970 (subsequently rescinded); FASB, Statement of Financial Accounting Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," December 1984. In part, because of the overly-broad nature of that concept, the SEC found it necessary to issue additional guidance on revenue recognition. See, Staff Accounting Bulletin Codification, Topic 13, "Revenue Recognition."

77 See, for example, SFAS No. 13, "Accounting for Leases," No. 45, "Accounting for Franchise Fee Revenue," No. 48, "Revenue Recognition When Right of Return Exists," No. 49, "Accounting for Product Financing Arrangements," No. 50, "Financial Reporting in the Record and Music Industry," No. 51, "Financial Reporting by Cable Television Companies," and No. 66, "Accounting for Sales of Real Estate," APB Opinion No. 10, "Omnibus Opinion - 1966," ARB No. 45, "Long-Term Construction-Type Contracts," AICPA Statements of Position No. 81-1, "Accounting for Performance of Construction-Type and Certain

Production-Type Contracts," and No. 97-2, "Software Revenue Recognition," EITF Issue No. 88-18, "Sales of Future Revenues," No. 91-9, "Revenue and Expense Recognition for Freight Services in Process," No. 95-1, "Revenue Recognition on Sales with a Guaranteed Minimum Resale Value," and No. 95-4, "Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease."

78 See, FASB Project Updates, "Revenue Recognition," http://www.fasb.org/project/revenue_recognition.shtml.

79 Thus, fundamental to the FASB's establishment of scope is determining precisely what assets and/or liabilities are most relevant to the specific topic or project, what the appropriate measurement attribute is for those assets and/or liabilities, and the flow or changes in those assets and/or liabilities. Indeed, ideally, a simultaneous determination is required, with optimal scope depending on the substance of a standard and optimal substance depending on the scope.

80 See, for example, comment letter of Charles L. Maimbourg, Senior Vice President, Accounting Policy and Research, KeyCorp.

81 The existence of numerous exceptions to a standard are an indicator that, either the underlying principle may not be appropriate, or the scope of the standard is too broad.

82 For example, at the extreme, the scope of a standard could be "all transactions and events which affect the company's financial position." If so, the related standard would be: account for all transactions and events based on their underlying substance.

83 FASB member John Wulff's characterization at the FASB Roundtable Discussion on Principles-Based Standards, December 16, 2002.

84 See, for example, comment letter of Robert Laux, Director, External Reporting, Microsoft Corporation.

85 Recall from our earlier example on business combinations under the rules-based approach of APB Opinion No. 16 that financial reporting and, as a consequence, investor perception was impacted by a company's ability or inability to engineer the combination in a way to meet the pooling of interests criteria.

86 Additionally, SFAS No. 141 serves as a recent example of the standard setters ongoing efforts to identify areas of the literature which are rules-based and to replace those standards with those that are more objectives-oriented.

87 FASB, SFAS No. 141, "Business Combinations," June 2001, paragraph 9.

88 AICPA, Accounting Research Bulletin No. 51, "Consolidated Financial Statements," August 1959.

89 See Schipper, Katherine, "Principles-Based Accounting Standards" Accounting Horizons, March 2003, for a description of the process used by the FASB, including drawing upon academic research.

90 For comparative purposes, the table also includes a principles-only approach, an approach which has not been used in establishing standards on accounting for business combinations.

91 Examples include implementation booklets published by major accounting firms and articles published in professional journals.

92 This is a point that was raised by various participants at the FASB Roundtable Discussion on Principles-Based Standards, December 16, 2002.

93 See Section IV for a discussion of the GAAP hierarchy. Alternatively, this could be clarified at the time the GAAP hierarchy is redefined.

94 FASB, Proposal: Principles-Based Approach To U.S. Standard Setting, Oct. 21, 2002.

95 Section 302 of the Sarbanes-Oxley Act (Pub. L. No. 107-204, 2002) and the SEC's rules (Release No. 33-8124, "Certification of Disclosure in Companies' Quarterly and Annual Reports," August 29, 2002) require CEOs and CFOs to certify that the company's financial statements and other financial information present fairly financial condition and results of operations of the company. Additionally, U.S. auditing standards require consideration of the meaning of "present fairly in accordance with GAAP." AU §411 contains a discussion of the auditor's responsibilities in this area and these standards offer some worthwhile advice about fair presentation per se. In particular, the auditor should consider whether:

- The accounting principles that were applied and selected have general acceptance
- The accounting principles are appropriate in the circumstances
- The financial statements and notes are informative of matters affecting their use, understanding, and interpretation
- The information presented is classified and/or summarized correctly (that is, not too detailed or not too condensed)
- The financial statements reflect underlying transactions and events in presenting the financial position, operations, and cash flows within a range of acceptable limits.

Additionally, ASR No. 4 states that:

> Where financial statements filed with the Commission . . . are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statement will be presumed to be misleading or inaccurate despite disclosures contained in the [auditor's report] or in the footnotes . . .
>
> Stated differently, when the registrant fails to apply accounting principles with substantial authoritative support, no amount of disclosure can cure the problem. The corollary to that is also important. The other side of that coin says that even if the accounting is appropriate, without complete and transparent disclosure, the company's filing is still deemed to be deficient.

96 Current authoritative standards, of course, include many of these components.

97 As we have stated previously, professional judgment also is needed to apply rules-based standards. However, in applying rules-based standards, professional judgment is needed to determine where within the numerous scope exceptions and conflicting guidance the company's transaction falls. Indeed, in many respects, the exercise of judgment in an objectives-oriented regime is merely different than under a rules-based regime. When properly constructed, objectives-oriented standards provide a framework for the application of judgment which can result in more consistent judgments than under a rules-based regime.

98 Sometimes referred to as the "show me where it says I have to do it that way" mentality (comments made by participants at the Baruch Roundtable on "Shifting to a Principles-Based Accounting System: Will It Improve Financial Reporting in the U.S.?" February 11, 2003).

99 As we note in our discussion of costs and benefits, it is likely that there will be a net benefit since it is frequently quite expensive to engage the financial engineers.

100 Since rules-based standards require significant judgment to determine where within the complex maze of exceptions and internal inconsistencies a transaction falls, this security blanket may, in fact, provide a false sense of security to auditors. Regarding the role of the auditor, some research seems to indicate that auditors might be more willing to challenge aggressive accounting practices adopted by management in a more "flexible" accounting environment than in an environment of rigid rules. See Nelson, Mark W., "Behavioral Evidence on the Effects of Principles- and Rules-Based Standards," Accounting Horizons, March 2003. Importantly, however, this result appears limited to situations where the auditor is more experienced and in a "stronger" firm.

101 As we have seen, the objectives of financial reporting are to provide information that is useful for investment decision-making. Embedded in this objective is both that transactions should be properly accounted for and that disclosure should be clear and transparent. This is not to say that disclosure should act as a substitute for proper accounting. See, Accounting Series Release No. 4, "Administrative Policy on Financial Statements," April 25, 1938. Rather, as the FASB notes: "Some useful information is better provided by financial statements and some is better provided, or can only be provided, by notes to financial statements or by supplementary information or other means of financial reporting." FASB, Statement of Financial Accounting Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," December 1984, paragraph 7.

102 If the information provided is to be useful to investors, it should be provided in an understandable manner. As SFAC No. 2 notes: "Information provided by financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence." FASB, SFAC No. 2, paragraph 40.

103 In an attempt to more actively engage users in the standard setting process, on February 6, 2003, the FASB announced the creation of a User Advisory Council. According to the FASB, "the purpose of the Council is to assist the FASB in raising awareness of how investors and investment professionals, equity and credit analysts and rating agencies use financial information. The Council will serve as a resource to the FASB both in formulating its technical agenda and on specific projects that the Board undertakes." See, http://www.fasb.org/news/nr020603.shtml.

104 As we described earlier, a move towards objectives-oriented standard setting must be viewed within the context of the reforms mandated by the Act. Thus, as used here, the term "enforcement" is viewed in its broadest context. Enforcement would include not only the enforcement powers of regulatory and legal bodies such as the SEC and the Department of Justice, but it also would include the activities of the PCAOB through its inspection and disciplinary programs, corporate governance efforts of management, audit committees, and boards of directors, the responsibilities of independent auditors, and civil litigation.

105 SEC rules require that listed companies have audit committees that are composed of independent directors; see, Release No. 33-8220, "Standards Relating to Listed Company Audit Committees," April 9, 2003. Additionally, SEC rules require companies to disclose whether any members of the audit committee are audit committee financial experts; see, Release No. 33-8177,

"Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002," January 23, 2003.

106 FASB, Proposal: Principles-Based Approach To U.S. Standard Setting, October 21, 2002.

107 See, for example, AAER 1405 and 1410, June 19, 2001.

108 Comments by Sir David Tweedie, Chairman, IASB, made at the FASB Roundtable Discussion on Principles-Based Standards, December 16, 2002.

109 See, for example, Dye, R.A. and E.R. Verrechhia, "Discretion vs. Uniformity: Choices Among GAAP," Accounting Review, 1995 and La Porta, R., F. Lopez-de-Silanes, and A. Shleifer, "Law and Finance," Journal of Political Economy, 1998.

110 As noted earlier, this concern is, in part, caused by the confusion between principles-based standards and principles-only standards.

111 Comments by various participants at the FASB Roundtable Discussion on Principles-Based Standards, December 16, 2002 and by various participants at the Baruch Roundtable on "Shifting to a Principles-Based Accounting System: Will It Improve Financial Reporting in the U.S.?" February 11, 2003.

112 Release No. 33-8183, "Strengthening the Commission's Requirements Regarding Auditor Independence," January 28, 2003.

113 Readers are reminded that the Commission currently has rule proposals outstanding which would address the reporting of "critical accounting policies." See, Release No. 33-8098, "Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies," May 10, 2002. Additionally, the Commission's rules require that auditors communicate critical accounting policies and estimates with the company's audit committee. See, Release No. 33-8183, "Strengthening the Commission's Requirements Regarding Auditor Independence," January 28, 2003.

114 The chart contained in Section VI outlines other steps that are a necessary part of the implementation process.

115 See, for example, comment letter of Stephen J. Cosgrove, Vice President, Corporate Controller, Johnson & Johnson.

116 In that regard, the FASB noted that: "Certain aspects of the conceptual framework are incomplete, internally inconsistent, and lack clarity." For example:

- FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information, does not provide conceptual guidance necessary for making trade-offs in accounting standards focusing on, among other things, the primary characteristics of relevance and reliability and the qualities of comparability and consistency.

- Because of compromises necessary to issue it, FASB Concepts Statement No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," describes practices existing at that time, providing little, if any, conceptual basis for analyzing and attempting to resolve the controversial issues of recognition and measurement. Among other things, Concepts Statement 5 does not provide the requisite tools for assessing whether items should be measured at fair value and, if so, when (as it relates to initial and subsequent fair value measurements), at what level of aggregation, and how.

  - The revenue recognition guidance in Concepts Statement 5 is inconsistent with the guidance in other areas of the conceptual framework, in particular, the definitions of liabilities (and other

elements) in FASB Concepts Statement No. 6, "Elements of Financial Statements."

- The definitions in Concepts Statement 6, themselves, lack clarity. FASB, Proposal: Principles-Based Approach To U.S. Standard Setting, October 21, 2002, p.6.

117 While the liabilities are relieved as the earnings process occurs, the pattern of recognition of revenue is likely to differ from its pattern when recognized using the historical view of the earnings process. Thus, while the notion of the earnings process is not inherently inconsistent with the asset/liability view, its application to revenue recognition does require refinement from the approach currently in use.

118 See, FASB Concepts Statement No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises."

119 At its meeting of June 4, 2003, the FASB decided to add to its agenda a project on measurement.

120 FASB Project Updates, "Revenue Recognition," http://www.fasb.org/project/revenue_recognition.shtml.

121 FASB Project Updates, "Liabilities and Equity," http://www.fasb.org/project/liabeq.shtml.

122 FASB Project Updates, "Financial Performance Reporting by Business Enterprises," http://www.fasb.org/project/fin_reporting.shtml.

123 "FASB and IASB Agree to Work Together toward Convergence of Global Accounting Standards." FASB and IASB Joint Press Release, October 29, 2002.

124 Securities and Exhange Commission, Actions by FASB, IASB Praised, October 29, 2002.

125 FASB, Technical Plan at http://www.fasb.org/project/short-term_intl_convergence.shtml.

126 Id.

127 Examples include projects on business combinations, share-based payments, financial performance reporting, revenue recognition, and measuring financial instruments at fair value.

128 FASB, International Convergence Research Project, http://www.fasb.org/project/intl_convergence_research.shtml.

129 We believe, as noted earlier, that the IASB also must adopt a more objectives-oriented regime (as defined here) to help facilitate the convergence process.

130 Effective for 2005, companies which are listed on exchanges and markets within the European Community will be required to adopt IFRS for financial reporting purposes (with some exceptions).

131 We note, for example, that the issue of share-based payments (or stock compensation) is currently under consideration by both Boards. This is an area of the U.S. literature which is currently replete with rules because of the need to interpret the existing intrinsic value model of APB Opinion No. 25. The Boards will need to make similar decisions on when to address other such areas of the existing literature such as leases, derivatives, and derecognition of financial assets and liabilities.

132 Statement on Auditing Standards No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles," AU§411.18.

Although not specifically discussed, SEC rules and regulations also are Level A GAAP for public companies.

133 FASB, Statement of Financial Accounting Concepts No. 1, "Objective of Financial Reporting by Business Enterprises," November 1978.

134 We do not propose specific "levels" of the hierarchy within the authoritative literature. Rather, the authoritative literature is provided from the general to the specific. We anticipate that the appropriate bodies (i.e., PCAOB and FASB) ultimately will address the specific content and order of the GAAP hierarchy.

135 See, discussion in the previous section regarding the GAAP hierarchy.

136 The SEC staff addresses implementation questions in several ways including reviews of registrant filings, responses to "pre-clearance" submissions by registrants, and through the enforcement process. SEC staff views are sometimes communicated through announcements at EITF meetings or through Staff Accounting Bulletins.

137 See, Emerging Issues Task Force Issues Grouped by Type As of the March 20, 2003 Meeting at www.fasb.org/eitf/bytype.pdf. This total does not include other issues which were considered by the EITF but never formally added to its agenda.

138 Comments made by Sir David Tweedie at the FASB Roundtable Discussion on Principles-Based Standards, December 16, 2002.

139 See, for example, EITF Issue No. 99-17, "Accounting for Advertising Barter Transactions."

140 See, for example, comment letter of Frank H. Brod, Chairman, Committee on Corporate Reporting, Financial Executives International.

141 As we detail in the Chart in Section VI, many of the steps to adopt an objectives-oriented standard setting approach already are underway. Consistent with that, we note that more recently, the EITF has been addressing approximately half the number of issues per year as compared to its historical average number of issues per year.

142 The same holds true for guidance provided by the FASB staff.

143 For example, the EITF's international counterpart-the International Financial Reporting Interpretations Committee ("IFRIC")-uses the following guidance in determining what issues to address: a) does the issue have widespread and practical relevance; b) does the issue involve significantly divergent interpretations (either emerging or already existing in practice); and c) is the issue unrelated to a Board project that is expected to be completed in the near future (if a Board project exists that is expected to resolve the issue in a short period, the IFRIC would likely not add the issue to its agenda). Additionally, the IASB approves IFRIC conclusions before they become authoritative.

144 See, EITF Topic D-1, "Implications and Implementation of an EITF Consensus."

145 The FASB also has stated its intention to seek greater input and involvement from the investor community in the standard setting process, including additional representation on the EITF and the formation of a User Advisory Council to provide input to the Board.

146 Comments made by several representatives of the preparer community at the FASB Roundtable Discussion on Principles-Based Standards, December 16, 2002.

While there currently are such databases available, it is often difficult for

147 accounting practitioners outside of major accounting firms or major companies to obtain information about content, access, and pricing about these services.

148 Conclusion based on comments made by representatives of the preparer community as well as comments made by members of the FASB at the FASB Roundtable Discussion on Principles-Based Standards, December 16, 2002.

149 It is our understanding that the staff of the FASB is currently investigating how to construct and maintain a web-enabled searchable database.

150 The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002). In particular, see Section 108(b) and Section 109 of the Act.

151 As our analysis has shown, many of the steps needed to implement an objectives-oriented standard setting approach in the U.S. are well underway. As a result, many of the costs already have been mitigated by the ongoing movement to objectives-oriented standard setting.

152 Byrnes, Nanette, "The Downside of Disclosure," Business Week, August 26, 2002, p. 102.

153 FASB, Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," November 1978, paragraph 34.

154 The complexity of certain accounting standards may go some way in explaining how the marketplace recently allowed accounting problems at major public corporations to brew for so long without an appropriate price correction. While the hints were there in some cases, few professionals-much less the average investor-tried to plumb them.

155 In particular, audit committee members are asked to participate in discussions with management and auditors about difficult accounting questions. For example, the SEC's protocol for submission of matters to the Office of the Chief Accountant asks that the registrant indicate whether the audit committee was consulted on the matter and whether the committee concurs with the company's position (see, "Guidance for Consulting with the Office of the Chief Accountant," http://www.sec.gov/info/accountants/ocasubguidance.htm). Additionally, auditors are required to discuss with the audit committee critical accounting policies used by the registrant as well as alternative applications of GAAP that are material to the company's financial statements (see, Release No. 33-8183, "Strengthening the Commission's Requirements Regarding Auditor Independence," January 28, 2003). Unless the audit committee is composed entirely of experts in financial reporting, it is difficult for members of the audit committee to properly gauge the appropriate accounting in difficult situations.

156 It is clear that strict adherence to GAAP does afford some degree of practical protection to accountants and management when they are involved in litigation. At a minimum, the ability to declare that defendants followed the rules will always constitute "good facts" for the defense. The competitive pressure on accountants to push these boundaries in order to please clients may be quite intense.

157 A recent study suggests that a rules-based approach increases earnings management through transaction structuring. See, Nelson, M., J. Elliott and R. Tarpley "Evidence from Auditors about Managers' and Auditors' Earnings Management Decisions," Accounting Review, 2002. (Interestingly, the same study indicates a reduction in earnings management obtained through management judgments.)

158 "Statement of Sir David Tweedie, Chairman, International Accounting Standards Board before the Committee on Banking, Housing and Urban Affairs of the United States Senate," Washington, D.C., February 14, 2002.

159 By informativeness, we mean the decision-usefulness of the financial reporting in terms of facilitating the assessment of the amount, timing, and uncertainty of future cash flows from an investment or credit decision.

160 As noted earlier, the term enforcement includes not just regulatory and legal enforcement mechanisms, but also, company audit committees, independent auditors, civil litigation actions, and the PCAOB.

161 Dye, R.A. and E.R. Verrechhia, "Discretion vs. Uniformity: Choices Among GAAP," Accounting Review, 1995.

162 A fundamental proposition in economics is that in a market context where there is uncertainty as to quality, consumers tend to discount all units of the good or service in question to reflect average, or expected, quality. As a consequence of this dynamic, when poor quality items (the "lemons") sell at the same price as good quality items-and all items are discounted to reflect the expectation of quality-the size of the market tends to decrease and average quality to fall, as poor quality items drive out the good. See Akerlof, G.A. "The Market for Lemons: Quality Uncertainty and the Market Mechanism." Quarterly Journal of Economics, 1970. This same dynamic can occur in financial markets, as companies with poor prospects attempt to mimic companies with good prospects through the manipulation of their accounting. In contradistinction, where good quality items (or companies) can effectively distinguish themselves from the lemons through signals to the market, this dynamic does not prevail. Such situations are called "separating equilibrium." See Spence, M. "Job Market Signaling" Quarterly Journal of Economics 1973. The key to arriving at such a separating equilibrium is that there must be a differential cost to sending the signal that indicates quality between those purveying actual quality and those attempting to mimic that quality. In the context of public reporting companies, it is enforcement that ensures that differential cost, thereby permitting companies with good prospects to effectively distinguish themselves from those without such prospects through their financial reporting.

163 As discussed subsequently, the incentives are different between rules-based and objectives-oriented standards. Under rules-based standards, management can take advantage of the "flexibility" offered by the rules since the bright-lines often provide a roadmap to engineer a desired accounting result.

164 See, for example, comment letter of Richard Levy, Senior Vice President and Controller of Wells Fargo and Company.

165 Use of a rules-based approach is only one reason that the standard setting process may be slow in responding to changes in the business environment.

166 For example, SFAS No. 13, "Accounting for Leases" has been amended and interpreted by approximately 25 Statements of Financial Accounting Standards, Interpretations, or Technical Bulletins. Additionally, another 35 EITF Issues have considered lease accounting issues.

167 There is one factor associated with an objectives-oriented regime that may work against issuing standards in a more timely fashion. As noted previously, an objectives-oriented approach bars the use of exceptions to the standards, or at least calls for minimal use of exceptions. (For ease of reference, let's call this "exception-barring.") Exceptions can play a role in the ability of a standards setting body to reach agreement. Exception-barring may, at times, preclude compromises by a standard setting body that would have helped in getting a standard issued in a timely fashion. Thus, exception-barring may, in some situations, work against the timely issuance of standards. Despite this fact, in net, we believe that objectives-oriented accounting would enhance the timeliness of the issuance of standards and would result in standards that are more durable, for the reasons outlined above.

168 We generally refer to current and potential investors and creditors by the more generic "investors," since investors may invest in either equity or debt instruments.

169 FASB, Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," November 1978.

170 As noted previously, these bright-lines also provide a roadmap to financially engineer a transaction to achieve a desired accounting result.

171 Comments made by James J. Leisenring, former member of the FASB and current member of the IASB, at the AAA/FASB Financial Issues Conference, December 7, 2002 in explaining the existence of many of the exceptions included in SFAS No. 133.

172 Some argue, for example, that the inclusion of a held-to-maturity category in the accounting for certain investments in accordance with SFAS No. 115 is an exception provided by the FASB to allow entities to avoid the earnings volatility that would result from marking-to-market those investments. See, for example, Schipper, Katherine, "Principles-Based Accounting Standards" Accounting Horizons, March 2003.

173 See, FASB, Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," November 1978. The importance of the conceptual framework to standard setting is explored in greater detail in our discussion of Implementation Issues.

174 "FASB and IASB Agree to Work Together toward Convergence of Global Accounting Standards." FASB and IASB Joint Press Release, October 29, 2002.

175 See, for example, comment letter of Tim Morrison, Group Controller, Shell International.

176 Here we use IFRS to refer to both the IFRS issued by the IASB and the IAS issued by its predecessor, the IASC.

177 Schipper, Katherine, "Principles-Based Accounting Standards" Accounting Horizons, March 2003.

178 See, for example, comment letter of Jack Ciesielski, R.G. Associates, Inc.

179 It is possible that objectives-oriented accounting standards could increase the vulnerability of accounting firms to "strike" suits by plaintiffs' attorneys. That is, by requiring a different application of judgment, objectives-oriented accounting standards also could generate greater uncertainty in the outcome of any given plaintiff's case. This increased uncertainty and expected expense may result in higher settlements for suits brought by the plaintiffs' bar, some of which constitute mere nuisance suits.

180 For example, with the issuance of SFAS No. 141, discussed earlier, the FASB eliminated the illusory comparability created by pooling of interests vs. purchase accounting portrayal under APB Opinion No. 16.

181 On the opposite end of the spectrum, it is certainly true that there may be a substantial lack of comparability if standards are principles-only, because of the heavy reliance on professional judgment without a sufficient structure to cabin that judgment.

182 One recent study finds that "financial reporting is less comparable when accounting standards rely heavily on the exercise of professional judgment than when standards place fewer demands on professional judgment." See Rentfro, Randall W. and Karen L. Hooks "The Tradeoff Between Comparability in Financial Reporting and the Level of Professional Judgment in Accounting Standards," 2002.

183 For example, the application of SFAS No. 141 is effective for business combinations entered into after June 30, 2001. Thus, combinations previously reported as pooling of interests continue to receive that treatment.

184 Section 108(d) of the Act.

a At its meeting of March 26, 2003, the FASB directed its staff to develop a proposal for a conceptual framework improvements project focusing on the selection of appropriate measurement attributes and related relevance and reliability issues.

b While there would be one standard setter (FASB), the SEC will continue in its oversight role with respect to the standard setter.

c At its meeting of March 26, 2003, the FASB established a near-term objective of using identical style and wording in the standards issued by the FASB and IASB on joint projects.

http://www.sec.gov/news/studies/principlesbasedstand.htm

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