U.S. Securities and Exchange Commission

Speech by SEC Staff: Remarks before the 2007 Conference on Principles-Based Accounting and the Challenges of Implementation

by

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Thank you. I certainly appreciate the opportunity to participate in this program. As some of you may know, I have been serving in my role as Deputy Chief Accountant for a little over 8 weeks. However, the topic of so called principles-based accounting is an issue that I have had an interest in for quite sometime and so I look forward to participating today. Before I go any further I must say that one of the things I have picked up on very quickly in my new role is that I need to remind you that the views I express here today are my own and do not necessarily reflect the views of the Commission, the Commissioners, or other members of the Commission staff.

Principles-based accounting standards have been the subject of discussion in the profession for a long time. However, some might observe that focusing on principles-based accounting sounds a little bit strange; after all, one of the fundamentals of financial reporting is Generally Accepted Accounting Principles or GAAP (not Generally Accepted Accounting Rules). In any case, the accounting scandals in the early part of this decade, the Sarbanes-Oxley Act of 2002 and the increasing complexity in the financial reporting system seem to have intensified the interest in this topic of so called principles based accounting standards. In fact, one of the requirements of the Sarbanes-Oxley Act was for the Commission to conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system. In July 2003, the Commission staff released a report (the 2003 Staff Report) to fulfill that requirement.[1] The staff report introduced the terminology "objectives-oriented" standards, in part to differentiate those types of standards from either rules-based or principles-*only* standards. Although the Staff Report clearly precedes my tenure as a Deputy Chief Accountant, in my remarks today I will highlight some of the discussion in that report and my own thoughts on how refocusing on principles-based (or objectives-oriented) standards might benefit investors. In that regard, I want to focus on the potential for objective-oriented standards to enhance consistency and comparability in financial reporting for the benefit of investors. I will also discuss some challenges facing the profession in endeavoring to refocus on objectives in the development and application of accounting standards.

It may be helpful to start with a brief explanation of objectives-oriented standards, as was laid out in the 2003 Staff Report:

> [T]he 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.

In fact, this explanation may help shed some light on why many might assert that U.S. standards are not as principles-based as those of the IASB. Personally I do not necessarily agree that accounting standards in the U.S. lack underlying objectives or principles. Rather, in some instances, exceptions, bright-lines and a volume of application guidance may appear to obscure the objective or principle underpinning the standard (or to state it another way the reporting of the economic substance of the business transaction). Take Statement 133 dealing with derivatives and hedging transactions (used as an example by many to criticize that U.S. standards are not based upon principles) as an example. I believe that Statement 133 at its core is based upon sound principles. The objectives of the standard are laid out in a few paragraphs and seem fairly straight forward (derivatives represent assets or liabilities, such assets and liabilities should be recorded at fair value, changes in fair value should be recorded in income and special accounting for hedging should be provided only for qualifying items). However, the standard is accompanied by 800 plus pages of implementation type guidance providing a host of well meaning scope exceptions, bright-lines, and rules. It is the volume of guidance, that in many cases makes it more difficult, rather than easier, to apply the standard. Accordingly, it is not hard to understand why someone could lose sight of the bigger picture. As I will mention again later, the idea is for there to be an appropriate amount of implementation guidance to help in applying the objective, but not so much additional guidance that the objective gets lost.

In addition to providing for objectives and a balanced amount of implementation guidance, it is essential that there be a coherent conceptual framework underlying accounting standards. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are in the process of improving their existing conceptual frameworks, and I encourage them to see that process through to completion.

Benefits to Investors of Optimally Designed Objectives-Based Standards

First, let me address the issues of consistency and comparability in a principles-based standards environment. I know that some believe that in the absence of bright lines and as we move forward in applying a different type professional judgment, comparability in financial reporting could be reduced. Further, some may believe that accounting standards that incorporate rules and bright lines help to achieve consistency and comparability in application of accounting from one company to the next, as presumably everyone will be applying the same rules and bright lines. However, I think what we've seen, in reality, is that comparability under a rules-based system can be an illusion. Similar transactions may be structured to fall just barely on opposite sides of a bright line, thereby receiving potentially very different accounting treatments. In that regard, are the economics of a lease transaction in which minimum lease payments equal to 89.9% of the fair value of the leased asset that different from one in which the minimum lease payments are just above 90%? Objectives-based standards, if properly constructed, should help to achieve actual comparability, based on economics, rather than illusory comparability. Principles-based standards should charge management with the responsibility for capturing within the company's financial reports the economic substance of transactions and events. And the objectives should frame what that "economic substance" is for the issue at hand.

In a regime that is overly proscriptive or "rules-based" where the focus is on compliance with a set of rules or where the rules detract from the objective the potential to create a smokescreen in which one might try and hide inferior financial reporting is introduced. Such a system also has the ability to foster an environment where structuring the terms of transactions to achieve an accounting objective without consideration of the true economics becomes acceptable. I believe that investors are better served when the role of accounting professionals is one of focusing on faithful reporting of business transactions rather than accounting professionals focusing on how to structure a transaction to result in the desired accounting outcome.

Challenges of Refocusing on Principles-Based Standards

Perhaps the one of the biggest challenges in the effort to focus on principles-based accounting is defining what a principles based standard should look like. In fact, I am not convinced that there is a common understanding of or agreement on what is meant by principles-based standards. Maybe some of the confusion comes directly from the definition of the word "principle(s)." In doing some research for today's conference, I went on-line in an attempt to see if the definition of a principle might in some way be insightful. Interestingly, especially in the context of a "principles versus rules" debate, the first definition of the word principle is "an accepted or professed rule of action or conduct." It wasn't until the 5th definition that you get to a definition that appears to be more objectives based, "guiding sense of the requirements and obligations of right conduct." In fact given the wealth of information on-line, I decided to look up the term accounting principles and the first site I clicked on defined accounting principles as "the accounting rules used to prepare financial statements..." While I certainly do not profess to have the answer, the 2003 Staff Report outlined one view of what objectives-based standards might look like. However, it is not clear to me that the profession is all on the same page when discussing principles-based accounting standards.

A second challenge is that having a clear accounting objective and principle that frame the economic substance of a transaction or event is likely not always enough. To help consistency of application, accounting standards often will need to include an appropriate amount of implementation guidance, consistent with the objectives and principles. The hard part may be in determining exactly how much, and what type, of implementation guidance is "appropriate". As I suspect the FASB and IASB can attest, there is great demand among accounting professionals for implementation guidance. Both during the process in which the FASB and the IASB create a standard and afterward, preparers of financial reports and their auditors ask many questions about how the accounting standard will apply to specific transactions and to specific situations. Accommodating all of those requests for more guidance can lead back to rules-based standards with potential illusory effects on comparability. Accommodating none of those requests can leave the impression that "anything goes" and again investors may suffer from lack of comparability.

While, again, I cannot provide the magic solution to this dilemma, a couple of observations may be helpful. First, any implementation guidance must be consistent with the objective of the standard. As we've seen with some current standards, implementation guidance in the form of bright lines and rules can lead accounting professionals to focus solely on that guidance, losing sight of any objectives or principles on which the accounting standard is based. Second, implementation guidance included by the standard setter within an accounting standard should have the same level of authority as the objective or other guidance within the standard. This is somewhat linked to the first observation, because when implementation guidance conflicts with the objectives, questions arise as to which takes precedence. When those questions have to be answered by yet another piece of accounting literature being issued (for example, an EITF consensus, an IFRIC conclusion, or a FASB Staff Position), we add to our existing accounting complexity. As a third point, I believe it is important for the standard setters to think carefully about whether the implementation guidance that is being contemplated is truly necessary. It should provide new information consistent with the objective, not simply restate the objective using different words.

Let me focus now on the role of judgment in a principles-based standards environment. Some may believe that any significant application of judgment in accounting will lead to non-comparability from one company to the next. It's important to keep in mind that it is likely impossible and in my view certainly not desirable to eliminate professional judgment from accounting, and I don't believe we should try to do so. Instead, if we are to move toward an objectives-based regime, we need to re-focus accounting professionals to spend their time applying judgment in the right areas — the principles or objectives, rather than specific rules. Of course this may require some training to refocus accounting professionals. However, if professional judgment of preparers and auditors is exercised in the interest of investors, principles-based standards have the potential to increase the transparency and comparability of financial reporting. In this regard, disclosure of transactions in which significant judgment is required seems like an extremely useful tool for management to describe the economics of a transaction, the business purpose and the judgments involved in reaching an accounting conclusion.

The next question that naturally comes to mind is whether preparers and auditors will exercise their judgment appropriately and honestly in an accounting regime with fewer rules? In this regard, I'm an optimist. I believe that this is exactly what the vast majority of accounting professionals strive to do on a daily basis. However, there appears still to be at least a few out there who are interested in engineering around accounting objectives or in asking questions like, "can you show me where it says that I can't do this?" As a very recent example, the SEC staff has become aware that certain parties have identified a series of transactions that might be described by them as an opportunity in adopting the FASB's recently released fair value option standard. The standard has a clear objective of improving the transparency of financial reporting. Accordingly, one might expect the opportunity that has been identified to be consistent with the objective of the standard. However, let me provide some background and describe one version of a structure and I hope you'll agree that these types of less than principles-based activities are not consistent with a call to reduce rules and complexity in accounting.

As part of the transition provisions, Statement 159 allows entities the option to elect to account for certain financial assets and liabilities that they hold upon adoption on a fair value basis. Further, companies can pick and choose which assets and liabilities, if any, to account for on a fair value basis. Upon electing fair value measurement any difference between fair value and carrying value of the asset or liability, including any amounts recorded in other comprehensive income, are recorded directly to retained earnings. However, once adopted for a given asset or liability the fair value election is irrevocable. Accordingly, some might suggest that an entity should elect the fair value option for certain existing investment assets where the carrying amount is less than fair value. This would provide for the ability to in effect write down the value of the asset without a charge to the income statement. While this might be provided for in the transition provisions, the series of events does not stop here. Rather, some might suggest that entities would then have the ability to sell the asset right after adopting the fair value option without recognizing a loss and then repurchase the same asset shortly after the sale and designate the assets as something other than a fair value investment. Unfortunately, in this case the "opportunity" appears to be one that could confuse investors rather than provide more meaningful information to investors. Engaging in this type of activity does not appear to promote the objective of the accounting standard. Accordingly, you can expect the SEC staff to continue to have an interest in such activities.

Some already question whether the SEC staff are or would be willing to accept reasonable views and interpretations in the application of accounting principles. I believe they are, and that we already do. However, there are best practices that preparers and auditors can take in that area to minimize later second guessing. I believe management and auditors should make appropriate judgments based on their facts and circumstances, and then document, at the time the judgment is made, the facts and circumstances, alternative approaches considered, and the reason for the final decision on the accounting. Management should then make clear disclosure in their financial reports about how they applied accounting principles, including the significant judgments they made. The ability of preparers and auditors to demonstrate reasonable, good faith judgments with contemporaneous documentation of the thought process and transparent disclosure may later help distinguish bad actors from the rest of the population.

I believe it is important for the financial reporting community, including the participants on this panel, to continue to discuss principles-based standards and how we can best achieve that goal. It does not serve any of our interests to write more rules in accounting when it is possible to articulate accounting objectives and principles. At the same time, we do a disservice to investors if we streamline the body of accounting literature so much that whatever preparers do, their treatment will fit within what is allowable. I believe we can get to objectives-based standards and reduce or eliminate much of the existing complexity embedded in the system and at the same time improve the content of information provided to investors, but we will not achieve this overnight. We all need to continue to focus our efforts in this area and there is almost universal support among companies, auditors, and investors that we must do something about the unnecessary complexity of our standards. Members of the OCA staff have certainly been thing about a framework for this needed and important effort. Thank you for your attention today.

Endnotes

[1] 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, released July 25, 2003.

http://www.sec.gov/news/speech/2007/spch040407jlk.htm