Accounting Standards: Are We Ready for Principles-Based Guidelines?

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Purpose
To summarize the issues and implications surrounding the possibility of an industry-wide change in accounting standards from a focus on detailed rules to a focus on broad principles. Experts from PricewaterhouseCoopers LLP (PwC) and the Financial Accounting Standards Board (FASB) answer thought-provoking questions about the impact of principles-based accounting standards on the industry overall.

Introduction

Over the years, there has been mounting concern that accounting standards have become too detailed and too complex. The FEI Research Foundation and PricewaterhouseCoopers LLP explored this issue with an on-line survey for financial executives responsible for financial reporting. The results are outlined in ***Financial Reporting Complexity***, an Issues Alert available at http://www.fei.org/rfbookstore/.

A significant majority (88%) of the respondents believe that current accounting and reporting standards are too complex, too difficult, and/or too costly to implement. Respondents offered suggestions to remedy this situation, with the most popular being:

- Standard-setters should develop standards that reflect the economics of the business transactions.

- Standards should be principles-based instead of being detailed "cook books" that attempt to provide accounting guidance for every possible transaction. (The IRS Code is an example of a "cook book" that prescribes how every transaction is taxed. Unfortunately, many people prefer to use it to look for tax loopholes, and unethical behavior results.)

- Regulators should encourage the exercise of judgment by preparers and auditors.

What would principles-based standards involve? What would the resulting implications be? We asked Jim Harrington and Ken Dakdduk of PricewaterhouseCoopers LLP (PwC), and John Wulff and Kim Petrone of the Financial Accounting Standards Board (FASB), for some answers. Jim Harrington is a partner in the national office of PwC where he serves as the leader of the firm's National Technical Services group. Ken Dakdduk is a PwC partner assigned to that group and was the partner who led the FEI/ PwC joint survey on financial reporting complexity. John Wulff is a Board Member of the FASB, and Kim Petrone is a Project Manager at the FASB.

Q&A

Eighty-eight percent of the respondents to our survey indicated that accounting has caused this trend standards are becoming more complex and too detailed. Do you agree with that, and, if so, what do you think?

PwC: We do agree. Over the last 20 years we have seen a rise in the number of accounting standards that, while grounded in a basic principle, contain detailed rules that must be applied in almost a cookbook style. A number have come from the FASB. For example, FAS 13 may have been the first to be given the moniker of a "detailed cookbook set of rules." Many standards have been added since then, including FAS 87 and FAS 106 and, more recently, FAS 133, as amended, to name a few.

To some extent the more detailed and complex standards reflect the growing complexity of business transactions that the standards are aimed at reporting. However, they also reflect compromises made by standard-setters to provide exceptions to otherwise conceptually correct standards in order to meet the demands of constituents. In fairness to the standard-setters, we also think that detailed rules are considered important by some preparers and auditors who believe that without such rules, their accounting judgments, made in good faith, can be too easily challenged in what is an increasingly litigious environment.

FASB: We agree that there has been a tendency to issue more detailed accounting standards in a number of instances. In part, this reflects increasingly complex business transactions as well as the development of improved measurement tools. In addition, the complexity reflects the FASB's response to constituents' requests (primarily auditors and preparers) for standards that address specific questions/ transactions. Those requests are driven by preparers asking their auditors "show me where it says I can't do that," as well as by the concern of both parties that they'll be second-guessed by regulators or sued for misapplying or misinterpreting accounting standards.

The SEC staff's lack of tolerance in the past for other than uniform answers is another reason for those requests. Bright lines and very specific rules are safe havens for both auditors and preparers. Another reason for the complexity in standards has been the desire to reduce volatility in financial statements and to allow exceptions to the underlying principles for certain transactions.

A majority of the respondents think that switching to principles-based accounting standards is an appropriate way to deal with the increasing complexity. What is a principles-based standard and how would it work?

PwC: We believe that a principles-based standard is one that captures and reports the economic substance of a transaction. Although our thinking continues to evolve in this regard, we think to be principles-based, the standard should address broad scope issues, rather than narrow fact-specific matters. It also should contain few, if any, exceptions to the concepts that underlie the standard.

Basically, application of a principles-based standard should result in reporting and disclosure that conveys the underlying economic substance of transactions and provides increased transparency of information to the users of the financial statements. We also think it should result in similar transactions being treated similarly.

FASB: A principles-based standard articulates the objective to be achieved through application of the standard and, in fairly broad terms, the means of achieving that objective. In addition, a principles-based standard is one that is conceptually grounded. That is, the logic underlying a standard is based on the FASB's conceptual framework. In that respect, all of the standards the FASB has issued since its conceptual framework was completed *are* principles-based because the conceptual framework is the starting point for all of the Board's decisions. Therefore, we prefer to use the term "principle-only standards" rather than "principles-based standards."

The Board uses its concepts Statements in debating the issues and arriving at the general objective or principle of a standard; it then finds itself adding additional details to support those principles. Thus, the challenge for the Board under a principle-only approach to setting standards will be to not add detailed guidance once it has agreed upon the basic principles. For example, Statement 142, *Goodwill and Other Intangible Assets*, requires entities to determine the fair value of their reporting units. However, the Statement does not provide detailed guidance on how to determine fair value—it explains the objective of the measurement exercise and some general principles to be applied. Another challenge for the Board will be to revisit its conceptual framework and make it clear, complete, and consistent—something necessary for principle-only standards to be as effective as possible.

The FASB's *Statement of Financial Accounting Concepts* No. 2, *Qualitative Characteristics of Accounting Information*, outlines several characteristics that accounting information should possess to be useful for decision making. It mentions relevance, reliability, comparability and consistency, materiality, costs and benefits. Should these have any place in a principles-based framework?

PwC: Yes. Our perception is that these qualities are not as readily apparent in many of today's standards as they could be. Nonetheless, we believe that they would be effective as goals in the process of developing principles-based standards, particularly to test the viability of a principles-based standard. For example, one test could be that the principle(s), the standard, and the information produced by applying the standard should be capable of being understood by a reasonably informed businessperson. Certainly, in any framework, standards should pass a robust cost/benefit test.

FASB: Absolutely. Relevance, reliability, comparability and consistency, materiality, and costs and benefits are the qualitative characteristics that make accounting information useful and are discussed in detail in Concepts Statement 2. As noted earlier, all of the standards that the FASB issues are based on the concepts Statements and thus must consider all of those qualitative characteristics. If in developing a standard the Board does *not* consider and weigh those qualitative characteristics, it has not done its job. It is the detailed guidance that differentiates a "principles-based" standard from a "rules-based" standard—not consideration of the qualitative characteristics.

Detailed rules-based standards are generally thought to foster comparability. Assuming comparability is a good thing, can it be maintained under a principles-based approach?

PwC: As we mentioned, we think principles-based standards should result in similar transactions being treated similarly. So we believe comparability of information is a good thing. But we acknowledge that if a standard contains broad principles, it's calling for the preparer to make a judgment in interpreting and applying it. And, it is certainly possible for reasonable people to differ on a matter that involves subjectivity.

Thus, there may be some trade-off between the levels of comparability that might be achievable under a detailed rules-based framework versus a principles-based framework. Accordingly, although we believe the intent and spirit of a principles-based standard should not be hard to discern, we think a certain level of interpretive guidance would be necessary. However, if preparers interpret the standard consistent with its spirit, and keep in mind the economic substance of the transaction, we believe an acceptable degree of comparability can be maintained.

FASB: We believe that comparability *can* be maintained under a principle-only approach. To the extent that the detail rules in an existing standard has allowed, for example, Company A to apply different accounting than Company B to a similar transaction, that does not foster comparability. By eliminating the details and explaining the objective of the accounting exercise—for example, to determine fair value—application of the principles supporting that objective should result in comparability.

Arguably, standards that include less detail will require application of professional judgment and reasonable people may at times reach different conclusions. The SEC staff will need to accept that result for principle-only standards to work. However, a certain amount of comparability is lost any time estimates and assumptions are used—whether in applying detailed guidance or general principles. The question is whether auditors and preparers will have adequate tools to account for transactions and whether application of those standards will in most cases result in comparable results (when applied to a set of comparable facts and circumstances).

Do preparers really want less detailed standards? Won't they still want more guidance when accounting for specific transactions?

PwC: If our joint survey is any indication of the appetite that preparers have for less detailed standards, the answer is that they do want less detailed standards, and we believe they would be willing to accept the responsibility of exercising judgment in applying principles-based standards.

However, the extent to which they would be willing to do so could well depend on the extent to which their judgments will be second-guessed by regulators, auditors, investors, and others who have a stake in the reported financial information. In our view, whether a principles-based framework of standards can be successful will depend in no small part on the willingness of regulators to allow the system to work.

FASB: Preparers will appreciate an increased opportunity to apply reasoned professional judgment in accounting for transactions. In addition, more general standards will be easier to read and understand. On the other hand, less detailed standards would imply fewer exceptions, alternatives, or "smoothing devices." Moreover, while broader standards are easier to understand, they are not necessarily easier to apply. We believe that all of the Board's constituencies will need to adjust to having less detailed standards—it will be a learning process, but everyone will be learning together.

What do you believe auditors think about detailed standards? Would they be in favor of principles-based standards?

PwC: Auditors who audit mainly by "checking off the boxes" in the audit program, instead of gaining an appropriate level of understanding of the client's business and analyzing the substance of a transaction, probably appreciate detailed standards. Auditors who need to be able to point to a detailed rule to get their clients to do the right thing also probably appreciate detailed standards.

However, the auditor who relies on detailed standards in this manner faces a dilemma when the client's position is "show me where it says I can't do this." We believe that detailed rules-based standards encourage financial and accounting engineering to get around the prescriptions in the standard, often to the detriment of reporting the true economic substance of a particular transaction. We believe that opportunities for such engineering would be significantly reduced in a principles-based framework. Accordingly, we believe that auditors who are intent on making sure that the financial information they are reporting on is a faithful representation of the activity the information purports to convey should be in favor of principles-based standards.

FASB: Detailed standards provide auditors with a crutch to lean on when a client prefers to use a less desirable approach to account for a certain transaction. And the details certainly provide a comfort factor when it comes to potential litigation. Will auditors be in favor of principle-only standards? They should be, as it will allow them to apply their professional judgment rather than just check off the boxes. In addition, there will be fewer rules to digest and understand—the body of accounting literature should be much more manageable; thus they'll have more time to focus on the important issues—their clients' financial statements.

Application of principle-only standards will require a change in the mindset of all involved in financial reporting. That change will be a shift from focusing primarily on compliance with the rules to focusing on whether financial statements accurately communicate the financial performance of a company.

What about regulators, investors, and analysts? Do they prefer detailed standards?

PwC: Where the facts in a specific transaction are similar from entity to entity, detailed standards should enable users of each entity's financial statements to see basically the same results. However, we think detailed standards are becoming less apt to achieve this result for the reasons we've cited. Given a choice between continuing on with bright lines in detailed rules-based standards, which may not adequately capture the economic substance of transactions, or moving to standards intent on capturing and reporting what really happened as a result of a given transaction, we think regulators, investors, and analysts will choose the latter.

FASB: As with the other groups, detailed standards mean more to digest and understand—as noted above, that's probably not the best use of anyone's time.

What would have to happen if, for example, the FASB reduced the detail in its accounting standards? How do you think that the various groups would respond?

PwC: Given that everyone is growing more and more accustomed to receiving detailed standards, a switch to principles-based standards is likely to leave some feeling there is a void. For example, initial reactions may be to call for additional guidance if entities feel that the broad general standard is not responsive to the unique aspects of their business or industry or they're not certain how it should be applied in their environment.

In our view, most people will be fully capable of making reasonable interpretations of the provisions of a principles-based standard. What gives them reason to pause is the concern that they'll be second-guessed by their auditors, by regulators, or by others.

These groups need to work together. As we suggested earlier, financial statement preparers must be willing to interpret and apply the standards within the spirit of the rule. Auditors must have the resolve to bring to light situations where the standards are not being applied as intended. And, regulators must be willing to allow the system to work.

FASB: The FASB plans to discuss this issue with its various constituent groups before any major shift is made in how the Board sets standards. The Board believes the time is right—but everyone has to move together. If nothing else, all parties involved can have a healthy debate on this long-standing issue and hopefully resolve it one way or another.

Does that mean there should be no body issuing interpretive guidance for principles-based standards?

PwC: No. Interpretive guidance is important in any framework of rules and regulations. However, the extent to which such guidance is sought can be significantly reduced from the level it is at today if the groups we mentioned are each willing to do their part.

FASB: No, there will always be the need for interpretive guidance. The question really is how detailed should that guidance be? One could argue that the details the Board might leave out of its standards under a principles-only approach would be the level of detail that an interpretive body would provide—it would not be the level of detail that some EITF issues address.

What are posible other implications of new accounting standards with less detail?

PwC: We mentioned the litigious environment. We think the effectiveness of principles-based standards would be enhanced if there were increased "safe harbor" protection that would create an environment that is more conducive to entities making good faith judgments, and providing better and more informative disclosures.

FASB: One necessary consideration is what type of authoritative body should be providing any necessary interpretive guidance. Some believe that interpretive guidance should be provided by the FASB, not by the EITF. That is, the FASB would issue less-detailed standards and, to the extent necessary, any follow-on interpretive guidance.

Next Steps

This report has described some of the issues involved in a possible transition from accounting standards with detailed rules to standards based on broad principles. It has also anticipated how some of the FASB's constituent groups might react. Please keep these issues in mind as you comment on the Board's current projects and as you ask for more guidance on particular transactions.

The FASB has agreed to evaluate the feasibility of issuing standards that emphasize basic principles. It plans to have suggestions to share with the public and use as a basis for discussion with constituent groups in the summer of 2002. The constituents' response to the FASB's efforts will help determine the future of standard setting.

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