

FINANCIAL REPORTING

Principally Speaking, Standards Need Rules

When the Financial Accounting Standards Board's (FASB's) exposure draft on its statement for business combinations comes out later this year, it will reflect a new way of thinking for audit committees that oversee corporate financial statements.

The exposure draft also helps point the way toward the gradual process of principles-based, or objectives, accounting. The exposure draft is expected to mark a change from a standard-setting process that has provided specific guidance for more than 20 years, having evolved into a rules-based system.

Many in the financial reporting community say that a principles-based system might lead to a lack of consensus on accounting, and the possibility of shareholder lawsuits. Some audit committee members have expressed concern they'll need more time to do their jobs under a principles-based system. In addition, many believe that regulators—including the Securities and Exchange Commission (SEC)—have yet to fully appreciate the fact that management, auditors, and audit committees will have to make more judgment calls than in the past.

What's more, the standards are evolving against the backdrop of more SEC regulations borne out of the corporate accounting scandals of the past several years. In a July 2003 study, the SEC weighed in on the adoption of a principles-based accounting system in the United States, as called for under the Sarbanes-Oxley Act of 2002. The SEC study referred to the use of "bright lines," or specific rules, and exceptions as a "game" that becomes more complex as standard setters attempt to fill loopholes and "financial engineers" find ways around them.

"I'm amused that people say we have a checkbox mentality," says C.H. Moore Jr. of Dallas, who serves on three audit committees, including chairman for Perot Systems and Kronos Worldwide. "But when you get government regulations like we have, you have to comply with them. "With the SEC wielding a hammer in its hand, it could come down at any time," says Moore, who also serves

on NL Industries audit committee. "The SEC has to let the judgment of the audit committee stand, if it's within reason."

One accounting professor who was an academic fellow with the SEC in 2001 believes the shift to more subjective judgments from bright lines will be one of the greatest challenges for audit committee members. "It will involve a lot more work," says Vivek Mande, director of Cal State Fullerton's Center for Corporate Reporting and Governance.

"There will be certain areas where it won't be clear which direction to go. "[Audit committees] will have to know to ask the right questions. They need to understand the objective. And they will need a lot more time, training and there will be a lot more documentation."

Mande is most worried about the audit committees of smaller firms. "In Orange County [Calif.], there are a lot of small, bustling firms," he says. "They are having problems getting independent committee members with financial expertise. On average, it's costing them \$90,000 per member." Audit committees at smaller companies—facing higher costs and with fewer resources than large firms—may have difficulty overseeing the complex judgments in a principles-based system, Mande says.

But many accounting observers agree FASB's change in its guidance-setting process will be gradual and include implementation guidance, although not like the bright lines that some corporations might have used to reach desired results in their financial reporting. Mark M. Bielstein, an audit partner in KPMG's Department of Professional Practice, believes judgment will be the operative word in a principles-based system, especially when you consider that such a system may, in many cases, be absent exceptions or bright lines. "It may be more challenging for auditors and audit committees to make and evaluate those subjective judgments," he adds. But just when will corporations start seeing full-scale changes in the accounting system? It may be a long while. "It's very uncertain [that] you're going to see strictly principles-based standards," says Joel Seligman, the dean of Washington University's School of Law in St. Louis. "In its 2003 study on objectives-based accounting, the SEC was somewhat tepid. There isn't even a proposal on the table yet."

Seligman, who also sits on the audit committee of NASD, says that when the dust settles, there will be a hybrid standard-setting process. Katherine Schipper, a FASB member since 2001, has written extensively on principles-based accounting standards. In a March 2003 *Accounting Horizons* commentary, Schipper wrote that the requirement of professional judgment under principles-based accounting might conflict with the need for rules or guidance that preparers will seek. She wrote: "If the Sarbanes-Oxley Act opens the door to ever more detailed legal prescriptions for the behavior of officers and directors, I predict that preparers of financial reports and the audit committees charged with oversight of the process will seek ever more detailed guidance as to precisely what is expected in terms of their role in financial reporting. That is, they will seek rules."

FASB has had an ongoing dialogue with the SEC about how to establish such a system since October 2002 when FASB wrote its "Principles-Based Approach to U.S.

Standard Setting" proposal. FASB received 135 comment letters regarding that proposal with many in favor, but some questioned its timing. Those in favor included CFOs, the California Public Education Retirement System, and the American Institute of CPAs (the latter, with some caveats). Those voicing concern included external auditors. In its response last month to the 2003 SEC study, FASB agreed with the finding that although its existing standards are based on principles, they could be written more clearly.

The SEC, which submitted that study to the Committee on Banking, Housing, and Urban Affairs of the Senate and Committee on Financial Services of the House of Representatives, also agreed, stating that some kind of written guidance would be needed. The change to a principles-based system is part of an overall simplification and codification project that is taking place as FASB also works on converging its standard-setting process with the International Accounting Standards Board (IASB), which is developing international financial reporting standards. "There's no timetable, per se," says Kim Petrone, FASB director of planning, development, and support activities. "It will be a gradual change in how we develop standards."

She pointed out that the exposure draft on the board's statement on business combinations, due in the fourth quarter, will be the first to reflect stricter principles-based accounting as well as the use of the IASB's black letter/gray letter style. That's where bold print letters are used to emphasize basic requirements of a standard and gray lettering is used for explanatory text.

Article written by Gary Larkin, Managing Editor, Audit Committee Insights.

Originally published August 25, 2004.