SEC Issues Study on the Adoption of a Principles-Based Accounting System

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The Securities and Exchange Commission (SEC) staff in the Office of the Chief Accountant and the Office of Economic Analysis recently prepared a study on the adoption of a principles-based accounting system by the US financial reporting system. The SEC staff study, which was conducted pursuant to the provisions of § 108(d) of the Sarbanes-Oxley Act of 2002 (SOA), was submitted to the Committee on Banking, Housing, and Urban Affairs of the US Senate and the Committee on Financial Services of the US House of Representatives. Specifically, the study:

- Provides the historical background to accounting standard setting in the United States, including (a) a description of the current conceptual framework and (b) the roles of the various participants in the standards-setting process;
- Details the current status of US standards with respect to the extent to which they might be deemed as principles based or, alternatively, rules based;
- Covers the components of an objectives-oriented principles-based approach to standards setting;
- Covers the practical issues raised in the implementation of an objectives-oriented principles-based approach to standards setting;
- Provides the economic and policy analysis of adopting objectives-oriented standards in the United States and the issues that bear on that analysis including (a) improved accessibility to and informativeness of financial information for investors; (b) better alignment of preparer and auditor incentives with investors’ interests; (c) enhanced quality, consistency, and timeliness of standards setting; (d) the provision of a vehicle for convergence with international accounting standards; (e) cost of accounting services; (f) comparability issues; (g) litigation uncertainty; and (h) transition costs;
- 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 standards setting in the United States.

The SEC staff conducted its study of the approaches to standards setting and found that imperfections exist when standards are established on either a rules-based or a principles-only basis. The SEC staff noted that principles-only standards may present enforcement difficulties, because they provide little guidance or structure for exercising professional judgment by preparers and auditors. The staff also noted that rules-based standards often
provide a vehicle for circumventing the intention of the standards.

In the SEC staff’s view, US generally accepted accounting principles (GAAP), despite being the historical product of a mixture of standards-setting approaches, constitutes the most complete and well-developed set of accounting standards in the world. Even though the standards vary significantly in their level of detail, adherence to a conceptual framework, and reliance on objectives and rules, the SEC staff stated that neither US GAAP nor international accounting standards, as currently comprised, are representative of the optimum type of principles-based standards.

The SEC study recommends the adoption by the US financial reporting system of a principles-based accounting system. The SEC staff distinguished its particular approach to implementing principles-based standards setting, which it labeled “objectives-oriented.” In the SEC staff’s view, an objectives-oriented standard has the following characteristics:

- Is based on an improved and consistently applied conceptual framework;
- Clearly states the accounting objective of the standard;
- Provides sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis but avoids providing too much detail (that is, avoids trying to answer virtually every possible question within the standard itself) such that the detail obscures or overrides the objective underlying the standard;
- Minimizes exceptions from the standard;
- Avoids the 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 SEC staff study notes that fundamental to the objectives-oriented approach is that the standards would clearly establish the objectives and the accounting model for the class of transactions while providing management and auditors with a framework that is sufficiently detailed for the standards to be operational. The SEC staff concluded in the study that an objectives-oriented approach should ultimately result in more meaningful and informative financial reporting to investors and would hold management and auditors responsible for ensuring that financial reporting complies with the objectives of the standards.

**DISADVANTAGES OF THE EXISTING STANDARDS**

The SEC staff noted that, in contrast to objectives-oriented standards, rules-based standards can provide a road map to avoidance of the accounting objectives inherent in the standards. It noted that internal inconsistencies, exceptions, and bright-line tests reward those willing to engineer their way around the intent of the standards. This can result in financial reporting that is not “representationally faithful” to the underlying economic substance of transactions and events. The SEC staff also noted that, in a rules-based system, financial reporting may be seen as an act of compliance rather than an act of communication. In addition, because the multiple exceptions lead to internal inconsistencies, significant judgment is needed to determine where within the myriad of possible exceptions an accounting transaction falls.

The result of principles-only standards can be a significant loss of comparability among reporting entities.

The SEC staff noted that, at the other extreme, a principles-only approach 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. The result of principles-only standards can be a significant loss of comparability among reporting entities. In addition, under a principles-only standards-setting regime, the SEC staff noted that 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 plaintiffs.
ADVANTAGES OF ADOPTING OBJECTIVES-ORIENTED STANDARDS

The SEC staff stated that 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. Auditors would be held responsible for reporting whether management has fulfilled that responsibility.

The SEC staff noted that objectives-oriented standards would place greater emphasis on the responsibility of both management and auditors to ensure that the financial reporting captures the objectives of the standards than do either rules-based standards or principles-only standards. It also noted that, if properly constructed, 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.

The SEC staff study states that objectives-oriented standards would 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. Because objectives-oriented standards would 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.

The SEC staff also noted that an objectives-oriented approach would provide the means by which management and auditors may be held accountable for reporting the substance of transactions within the financial statements. The SEC staff stated 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, the SEC staff concluded that an objectives-oriented approach should ultimately result in more meaningful and informative financial statements.

In addition, the SEC study states that, under an objectives-oriented system, the cost to investors and analysts of comprehending the standards themselves would be lower. 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 (a) how the standard is constructed, (b) how it is to be applied to a class of transactions or events, and (c) how those transactions or events should be reflected in the company’s financial statements.

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

The SEC staff also stated that an additional benefit of objectives-oriented standards is the facilitation of greater convergence between US GAAP and international accounting standards (see related article, “IASB Issues a Standard on First-Time Adoption of International Financial Reporting Standards,” in this issue). It noted that standards setters can come to an agreement on a principle more rapidly than they can on a highly detailed rule. The study notes that the benefits of convergence include greater comparability and improved capital formation globally.

IMPLEMENTING AN OBJECTIVES-ORIENTED APPROACH

The SEC staff acknowledged that US standards setters have begun the shift to objectives-oriented standard setting and are doing so on a prospective, project-by-project basis. The SEC staff expects that the Financial Accounting Standards Board (FASB) will continue to move toward objec-
tives-oriented standards setting on a transitional or evolutionary basis. The SEC staff noted, however, that specific steps must be taken to continue the process of implementing a more objectives-oriented regime in the United States.

The SEC staff anticipates that the change should occur as the FASB examines specific topics in the course of carrying out its standards-setting process. In addition, a comprehensive review of the existing body of authoritative literature is under way to serve as a basis for agenda decisions and priorities. The SEC staff noted that key steps needed to implement an objectives-oriented regime in the US standards-setting process include the following:

**FIGURE 1**

SEC Staff Table: Steps Required to Move the US Standards-Setting Process to an Objectives-Oriented Approach

<table>
<thead>
<tr>
<th>Action Items</th>
<th>Current Status</th>
<th>Time Horizon</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conceptual framework improvements project</td>
<td>FASB currently evaluating most efficient approach</td>
<td>Medium term</td>
</tr>
<tr>
<td>Move toward objectives-oriented form of standards</td>
<td>Recent standards (for example, SFAS No. 141, “Business Combinations,” and following) have included elements of objectives-oriented form</td>
<td>Immediate</td>
</tr>
<tr>
<td>Comprehensive review of current standards to identify and address those that are rules based</td>
<td>SFAS No. 141 superseded APB Opinion No. 16, “Business Combinations” (rules based); accounting for stock-based compensation added to FASB agenda on March 12, 2003; staff and FASB are evaluating existing standards for purposes of future agenda decisions</td>
<td>Under way</td>
</tr>
<tr>
<td>One standard setter</td>
<td>The AICPA Accounting Standards Executive Committee (AcSEC) will no longer be responsible for issuing “authoritative” standards; transition plan is in place; EITF consensuses now are subject to FASB approval</td>
<td>Under way</td>
</tr>
<tr>
<td>Redefine GAAP hierarchy</td>
<td>Conceptual framework improvements project to be completed first</td>
<td>Medium term</td>
</tr>
</tbody>
</table>
| Convergence                                      | In October 2002, FASB and IASB jointly announced intention to work toward convergence of international and domestic standards. Joint or cooperative projects under way include business combinations, measuring financial performance, stock-based compensation, revenue recognition, and short-term convergence | Under way, some standards expected to be issued within the next year but effort will be long term
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- Ensure that, when new standards are developed, they (a) are aligned with an improved conceptual framework, (b) articulate the accounting objectives, and (c) avoid scope exceptions, bright lines, and excessive detail;
- Address deficiencies and inconsistencies in the conceptual framework;
- Address current standards that are more rules-based;
- Redefine the GAAP hierarchy;
- Continue efforts on convergence of US, foreign, and international accounting standards;
- Establish authoritative implementation guidance;
- Increase access to authoritative literature.

The SEC staff provided the table shown in Figure 1 to outline the key steps required for the US standards-setting process to move to a more objectives-oriented approach.

CHANGES TO THE CONCEPTUAL FRAMEWORK

The SEC staff stated that having a clear, consistent conceptual framework is a necessary step in facilitating a move toward a more objectives-oriented regime. Currently, the FASB uses its conceptual framework in the process of developing accounting standards; however, there appears to be general agreement that there is a need for the FASB to undertake a “conceptual framework improvements” project as part of such a shift to a more principles-based regime.

The SEC staff also stated that there are three key issues that the FASB should address relative to its conceptual framework in order to move toward an objectives-oriented regime:

1. More clearly articulate how the trade-offs among relevance, reliability, and comparability should be made;
3. Establish a paradigm for selecting from among possible measurement attributes.

The SEC staff noted that the FASB’s conceptual framework acknowledges the need to make trade-offs among the qualitative characteristics of relevance, reliability, and comparability; however, it does not provide a useful structure or guide as to how the trade-offs should be made. The SEC staff stated that it recognizes that the determination of the proper trade-off is a key part of the FASB’s responsibility in establishing accounting standards. If the basis for making the trade-off were more clearly articulated, it would provide both the FASB and the accounting profession with a clearer road map to understand the spirit as well as the letter of a new standard. Doing so would necessitate a change, primarily to SFAC No. 2, “Qualitative Characteristics of Accounting Information.”

The FASB’s conceptual framework acknowledges the need to make trade-offs among the qualitative characteristics of relevance, reliability, and comparability.

The SEC staff noted that the asset/liability view is fundamental to the FASB’s ability to draw upon the conceptual framework in its standards-setting efforts. Unfortunately, the asset/liability view and the historical notion of an “earnings process” for recognition of revenue are not completely consistent. The report states that the FASB should maintain the asset/liability view in continuing its move to an objectives-oriented standards-setting regime; it also stated 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. The SEC staff noted that it recognizes 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 SEC staff noted that the third aspect is the need to
provide guidance on the determination of the appropriate measurement attribute. As the FASB acknowledges, financial reporting currently is based on a “mixed-attribute” model. 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. In addition, there is confusion about when adjustments to carrying amounts are recognized in earnings.

The SEC staff stated that the FASB’s shift to an objectives-oriented regime should be greatly enhanced by an articulation of “concepts” for the use of various measurement attributes, because measurement is a key element of any accounting standard. Doing so would necessitate significant modifications to SFAC No. 5 and, possibly, SFAC No. 7, “Using Cash Flow Information and Present Value in Accounting Measurements.” The SEC staff noted that many projects on the FASB’s agenda can form the basis for the work that should be done on the conceptual framework. For example, the SEC staff provided the following:

- The FASB’s current project on revenue recognition could form the basis for eliminating the inconsistencies between SFAC Nos. 5 and 6 on revenue recognition.
- The FASB’s current project on liabilities and equity could address some of the questions about definitions of elements of the financial statements and form much of the basis for needed clarification to the definition of the elements.
- The FASB’s current project 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.

**REDEFINE GAAP HIERARCHY**

The third step in the process of implementing a more objectives-oriented regime in US financial reporting is a realignment of the US GAAP hierarchy. The SEC staff noted that it would envision a change in the US GAAP hierarchy at that point such that authoritative literature would appear more along the lines of the following:

- FASB conceptual framework documents.
- Emerging Issues Task Force (EITF) consensuses (see following discussion about the need for interpretive guidance) and FASB staff positions.
- Nonauthoritative literature would include industry group positions and positions of knowledgeable professional organizations or entities.

The SEC noted that the 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). This shift in the hierarchy would be a necessary part of the shift in behavior, which is needed among preparers and auditors to aid the FASB’s shift to a more objectives-oriented regime.

**CONTINUED EFFORTS ON CONVERGENCE**

The SEC staff stated that the FASB’s shift to a more objectives-oriented regime is an integral part of its stated intentions to seek greater convergence between US, foreign, and international accounting standards. Both the FASB and the International Accounting Standards Board (IASB) have stated their intention to seek greater convergence of US and international accounting standards, and the SEC endorsed that initiative. In working toward 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 those matters, the FASB has been charged with the lead responsibility in developing or achieving a converged, high-quality solution; for other items, the IASB is charged with that responsibility. The two boards have targeted December 31, 2003, to achieve most, if not all, of the items on the short-term convergence list.

In addition, the two boards have a long-term convergence strategy that will involve joint efforts on many of the boards’ current agenda projects as well as an international convergence research project whereby the FASB staff can accomplish the following:
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- **Identify all existing differences between US GAAP and international financial reporting standards (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 US GAAP and IFRS, that is, 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. The SEC staff noted that additional strategies may be identified as work progresses.

- **Provide input to the FASB’s agenda-setting process as needed to further the goal of convergence.** At the joint meeting of the FASB and IASB, 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.

The SEC staff stated that a continuing shift by the FASB toward a more objectives-oriented regime should facilitate the convergence process. Since the convergence project will require both boards to seek a high-quality solution to the accounting issues addressed within an objectives-oriented regime, the SEC staff noted that much of the transition toward 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, the SEC staff expects that the boards will work most intensely through 2004 and, possibly, into 2005 in an effort to achieve a significantly improved degree of convergence.

The SEC staff noted that the determination of the boards’ respective agendas will be a part of this process. This includes 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.

**ESTABLISHING IMPLEMENTATION GUIDANCE**

The SEC staff noted that 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. The SEC staff stated that there will be questions that arise as accounting professionals attempt to apply the standards to specific fact patterns. The implementation guidance will likely be developed as formal guidance and 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.

**One of the key issues in an objectives-oriented regime is who should provide implementation guidance.**

**Formal guidance.** The SEC staff stated that there will continue to be a need for a body of experts to address and resolve certain implementation questions. In the United States, that body has, since 1984, been the EITF and should continue to function to address certain implementation questions that arise; however, under an objectives-oriented regime, the EITF would need to operate differently than it has under a rules-based regime.

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. The guidance that the EITF provides would need to be consistent with an objectives-oriented approach; thus, it would need to avoid use of bright-line tests and other tell-tale signs of a rules-based regime. To function consistently with the objectives-oriented regime, the FASB would be...
required to exercise greater control over the activities of the EITF. Consistent with that, the FASB recently announced several changes to the operating processes of the EITF:

- Two members of the FASB now serve on the EITF’s agenda committee. This will provide greater input from the FASB in deciding which issues should and, as important, which issues should not, be addressed by the EITF.
- The FASB must ratify EITF conclusions before they become authoritative. This creates a more formal structure to the task of providing implementation guidance relating to current authoritative standards.
- The task force members should represent increased diversity of experience. Beginning in January 2004, the EITF will include a representative from the investor community.

Informal guidance. The SEC staff noted that, as the EITF continues to function consistently 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. Consequently, there could be an increase in the demand for informal guidance.

Under an objectives-oriented regime, there cannot be a proliferation of standards setters.

There are several possible sources of such informal implementation guidance. These include the major accounting firms (either acting individually or collectively), professional organizations (including organizations such as the American Institute of Certified Public Accountants [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 SEC staff will continue to have a role in that process.

The SEC staff does not envision that those activities should cease under an objectives-oriented regime. Indeed, it is likely that some or all of those efforts will be extremely useful in enhancing comparability among reporting entities (particularly among entities that are clients of the same accounting firm). The issue, however, is what level of authoritativeness should the guidance provided by these entities and organizations have?

The SEC staff stated that it sees the authoritative literature to be the domain of the FASB (and, if necessary, the SEC). Other guidance should be relegated to the nonauthoritative category of the GAAP hierarchy. The SEC staff noted that the current status of many of the entities and organizations are currently included as informal guidance (for example, major accounting firms’ publications, FEI, IMA, industry trade groups, and the academic community). For the AICPA, however, this would constitute a major change (and downgrading) in the authoritativeness of its publications.

The SEC staff noted that, under an objectives-oriented regime, there cannot be a proliferation of standards setters. To allow for such a proliferation invites a shift back to a more rules-based regime. The SEC staff argued that many of the exceptions found in current standards exist because of the need to accommodate specialized industry practices found in AICPA industry guides and statements of position.

While the SEC staff did not deny that the AICPA has experience that can be very useful in addressing implementation questions that arise in an objectives-oriented environment, it stated that one professional organization or industry trade group should not receive primacy (in terms of the authoritativeness of its publications) over any other provider of informal implementation guidance.

INCREASING ACCESS TO AUTHORITATIVE LITERATURE

The SEC staff stated that, 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 standards setter. One of the concerns that accounting professionals have expressed is the lack of a single, searchable database containing all of the authoritative guidance.

The SEC staff stated that, with the technological capabilities currently available, such a database should be more readily available to accounting professionals. The database should...
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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 in order to address 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 standards setters, accounting professionals, and other key constituents that such a resource is needed. The SEC staff noted that the FASB should have the responsibility for developing and maintaining the resource and that the FASB’s documents should be freely available. The costs of providing such documents could appropriately be covered by the funding mechanism provided for in the Sarbanes-Oxley Act.
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