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THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

Ms Nancy M. Morris
Federal Advisory Committee Management Officer
Securities and Exchange Commission
100 F Street, NE
WASHINGTON
DC 20549-1090

By email: rule-comments@sec.gov

3 April 2006

Dear Ms Morris

Securities and Exchange Commission Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies

I am pleased to make a brief response on behalf of the Institute of Chartered Accountants of Scotland on one specific aspect of the exposure draft of the final report of the SEC Advisory Committee on Smaller Public Companies.

The Institute was the first professional accountancy body in the world. The Institute's Royal Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

We support the report's recommendation V.S.2 which encourages the FASB to continue to pursue objectives-based rather than rules-based accounting standards, and promote simplicity and ease of application when developing new accounting standards.

The Institute has today published the results of, and recommendations arising from, recent international research on the principles–rules debate in relation to accounting standards, a copy of which is attached and which we hope will be of interest to you. One factor which emerged from the research was the unanimous support expressed for principles-based standards and the wish to remove current levels of prescription.

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Whilst we support the Advisory Committee's recommendation regarding objectives-based rather than rules-based accounting standards, we believe that there is an important distinction to be made between 'principles-based' and 'objectives-oriented' standards. We believe that the desire to define the objective at 'an appropriate level of specificity' risks a reversion to what are, in substance, rules. We would support an objectives-based standard where the aim of the objective is to encapsulate a 'true and fair view' or 'fair presentation' in the purpose of the standard, and the objective is consistent with the broader principles contained within the conceptual framework. We therefore recommend that the Advisory Committee considers defining 'objectives-based' accounting standards in this way within its final report.

I hope our comments are of assistance to you in the finalisation of this report. If you wish to discuss any of the above comments, please do not hesitate to contact me.

Yours sincerely

AMY HUTCHINSON
Assistant Director, Accounting & Auditing

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND

Principles not Rules:

A Question of Judgement

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OF SCOTLAND

Principles Not Rules

A Question of Judgement

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This report is dedicated to the memory of Aileen Beattie, former Executive Director of Technical Policy at ICAS, who died on 6 October 2005. With her customary enthusiasm, rigour and sensitivity, Aileen guided the Working Group in its initial focus on the key issues, established the framework and co-ordinated the arrangements for this project, including the interviews, workshops and desk-based research. Without her energy and commitment the publication of this report within the project's tight timetable would not have been possible. We are privileged to have worked with her.

Acknowledgements

The Institute would like to thank the members of the Principles versus Rules Working Group, the Critical Review Group, the workshop participants, the interviewees and the notetakers.

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It should be noted that the members of the Working Group and the Critical Review Group were acting in their personal capacity and were not representing the organisations for which they work.

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INTRODUCTION

The key to true and fair financial reporting is the balanced exercise of judgement. If standard setters, preparers, auditors and regulators could all exercise judgement on broadly equal terms, then this would provide the healthy tension which is needed for true and fair financial reporting and for communication with stakeholders.

Principles-based accounting standards are based on a conceptual framework, consist of a clear hierarchy of overriding principles and contain no 'bright-line' or anti-abuse provisions. Such an approach requires the use of judgement by preparers, auditors and regulators.

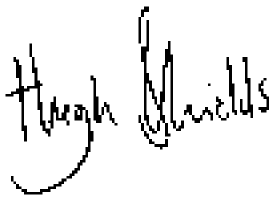
To underpin this environment, it is necessary to address the concerns of those who worry about the risk of lawsuit. It is fundamental that judgements can be demonstrated to be reasonable at the time they are made and in light of the facts and circumstances then present. The recent Interagency[1] Statement on Sound Practices Concerning Complex Structured Finance Activities (May 2004) in the US is highly instructive in this respect, even though it relates specifically to complex financial transactions. This Statement stresses that the careful generation, collection and retention of documentation throughout the life cycle of such transactions is critically important in minimising legal risk. The approach is valid to any transaction involving significant judgement.

With the safeguards afforded by such an approach, all parties should be more able to accept the consequences of exercising judgement in a principles-based accounting world.

Against the above background, much greater simplicity in standard setting becomes possible. An interviewee in this project noted that: "*Any accounting standard should be capable of being explained in one minute*". Yet some standards currently seem to defy any simple explanation at all. In the interests of all parties involved in financial reporting and, in particular, the broad range of users, such a situation should not be allowed to persist.

Einstein once said that *"Everything should be made as simple as possible, but not simpler"*. This perfectly captures the Working Group's view that accounting standards should be firmly governed by high-level principles with only the absolute minimum additional guidance required to make the standard operational.

Preparers and auditors would, therefore, need the courage to exercise and defend their judgements in this simplified accounting world. Users and regulators would need the wisdom to accept that there may be more than one answer and over time all parties would have to build the trust that this state of the world implies.



Hugh Shields
Chairman of the Working Group

Hugh Shields is a Director and Head of Financial Reporting at Barclays Capital, the investment banking division of Barclays Bank. Hugh is Convener of the Accounting Standards Committee at ICAS and is also a member of the European Financial Reporting Advisory Group Financial Instruments Working Group.

[1] Agencies: Office of the Comptroller of the Currency, Treasury; Office of Thrift Supervision, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Securities and Exchange Commission. The full text of the statement is available at http://www.occ.treas.gov/fr/fedregister/69fr28980.pdf

BACKGROUND

We, the Working Group, believe that the current position of an ever-increasing volume of accounting rules is not sustainable, especially during the process of global convergence of accounting standards. Concern has been expressed to us that compliance with a rules-based accounting framework does not necessarily result in financial statements that show a true and fair presentation of an organisation's commercial situation. We take the view that maintaining and adhering to a large, complex set of accounting rules creates insurmountable problems for standard setters, preparers of financial statements, auditors and users and, it is argued, the overriding objective of true and fair presentation can become lost in the quest for 'compliance'.

The Institute of Chartered Accountants of Scotland established a *Principles versus Rules* project to examine these issues, which consisted of:

- a Working Group to take the project forward;
- a Critical Review Group to provide oversight and challenge to the Working Group;
- a review of the professional, academic and regulatory literature on the *Principles versus Rules* debate in international accounting standard setting ('desk-based research');
- a workshop with financial instrument experts to explore whether, or to what extent, the current version of IAS 39 could be distilled into higher-level principles (the 'deconstruct workshop') (Appendix I);
- a workshop with a different group of financial instrument experts to explore what an alternative model for financial instruments might look like if started from scratch (the 'blank sheet workshop') (Appendix I); and
- interviews with influential figures in the world of accounting (Appendix II).

We begin our report by defining and explaining our vision of principles-based standards and we follow by explaining why rules-based standards are not sustainable. We then explore how a principles-based approach serves the public interest, we explain how it meets the needs of responsible enforcement and we consider the implications for a process of convergence which shows sensitive awareness of diversity in environment and culture.

Reports summarising the evidence collected in this project are listed in Appendix III and may be found at www.icas.org.uk.

Our Definition of a Principle

A principle is a general statement, with widespread support, which is intended to support truth and fairness and acts as a guide to action.

SUMMARY OF RECOMMENDATIONS

The Working Group's recommendations are as follows:

1. We support the consensus that only principles-based accounting standards can fully serve both the needs of business and the public interest.

2. It is necessary to recognise that complete comparability is never possible in accounting. More emphasis needs to be placed on explaining the key judgements made by preparers of financial statements. This is critical to effective communication in financial reporting.

3. Principles-based accounting requires a clear hierarchy of overarching concepts, principles that reflect the overarching concepts and limited further guidance. The additional guidance should be restricted to brief explanation built into the standards themselves, as well as a small number of interpretations on major issues.

4. Rules-based accounting adds unnecessary complexity, encourages financial engineering and does not necessarily lead to a 'true and fair view' or a 'fair presentation'.

5. Principles-based accounting provides a comprehensive basis for the preparation of financial statements that has the flexibility to deal with new and different situations as they arise and leaves far less scope for people to convince themselves that an 'inappropriate' interpretation is acceptable.

6. Our vision of principles-based standard setting will require a change in the global profession, with both preparers and auditors assuming more responsibility for their judgments and seeking less in the way of detailed guidance.

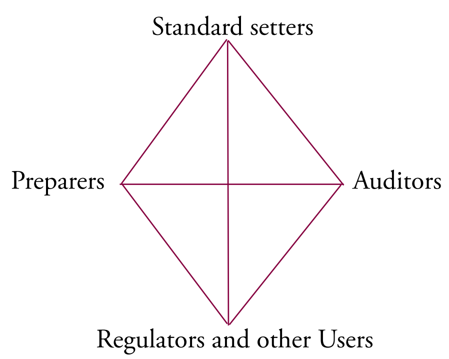
7. In order to implement these changes the training of both current and future professionals will need to be addressed to ensure that accountants have the expertise, and the courage, to make sound and ethical judgements in the overriding interest of a true and fair view. To support this approach, the judgements need to be documented and disclosed.

8. Responsible enforcement of accounting standards requires regulators to be willing to accept a range of judgement-based outcomes. Regulators need to be able to trust preparers and auditors, who in turn must be capable of exercising judgement (see The Diamond of Trust below). One corollary is that anti-abuse provisions and 'bright lines' should not be included in accounting standards.

9. A single interpretative body should focus on significant issues rather than detailed matters. Detailed matters should be left to the judgement of preparers and auditors with clear disclosure of how that judgment has been exercised.

10. Convergence cannot be achieved if the basis for convergence is a detailed rules-driven approach as this will be difficult to roll out across the different jurisdictions and cultures around the world.

The Diamond of Trust



A PRINCIPLES-BASED APPROACH

In this report we provide evidence of a clear concern that rules-based accounting standards have no future in the preparation of financial statements which aim to serve the public interest. We propose a principles-based approach to standard setting that seeks to provide a practical way forward and addresses the concerns of those who defend the need for rules in accounting standards. Our proposals recognise a range of opinions on this debate.

Defining a Principle

We define a principle as a general statement, with widespread support, which is intended to support truth and fairness and acts as a guide to action. Principles cannot be replaced by mechanical rules. Sometimes a set of rules may be proposed to guide the observance of a principle, but it will always be a matter of judgement whether following these rules will actually achieve conformity to the principle. We have offered this definition because it focuses on a high-level view and because it emphasises the importance of interpretation which requires judgement. We found dictionary definitions unhelpful because of circularity in linking principles and rules. We looked back to the 'principles and postulates' debates in the accounting literature of the 1960s and 1970s but felt that this was entangled with the history of disagreement on valuation, potentially detracting from a wider debate on a principles-based approach to all aspects of financial reporting.

Our definition is consistent with our discussions with opinion-formers and with our exploration of the issues surrounding accounting for financial instruments. An overwhelming majority of those involved told us they were looking for accounting standards to be firmly governed by high-level principles, to be wholly devoid of anti-abuse and 'bright-line' rules, and to be supported by the absolute minimum of additional guidance required to make the standard operational.

Accounting Standards should be firmly governed by high-level principles

Defining a Rule

We define a rule as a means of establishing an unambiguous decision-making method. There can be no doubt about when and how it is to be applied. Rules represent specific instructions – like a computer program. Rules are sometimes arbitrary and may not always reflect the underlying principles.

Context of the Current Debate

We are aware that the current debate on 'principles versus rules' is significantly influenced by section 108 of the Sarbanes-Oxley Act of 2002 which required the Securities and Exchange Commission (SEC) to examine the length of time required for a change from a rules-based to a principles-based financial reporting system and the feasibility and methods of implementing a principles-based system. We concur with the observations of the SEC, in its study published in 2003, that 'principles-based' does not mean 'principles-only'. We expect that a principles-based accounting standard will be accompanied by guidance. That expectation is supported strongly in the evidence from our investigations. We concurred with one commentator who said: *"guidance anticipates the use of judgement whereas rules discourage judgement"*.

We are supportive of the SEC's analysis of the limitations of rules-based accounting standards. However, we have not taken the SEC's route of equating principles-based standards with objectives-oriented standards because we believe that the desire to define the objective at 'an appropriate level of specificity' risks a reversion to what are, in substance, rules. We could support an objectives-oriented standard where the aim of the objective is to encapsulate a 'true and fair view' of the purpose of the standard and the objective is consistent with broader principles contained within a conceptual framework. This approach would impose an overriding objective against which to evaluate compliance with the overall spirit and not merely the letter of the standard. However, we are concerned at the SEC's idea that under an objectives-oriented standard 'the range within which professional judgement must be exercised is narrowed as compared to either a principles-only or a rules-based approach'. We believe this risks a focus on restricting judgement.

There has to be greater trust between and among regulators, standard setters, auditors, users and preparers of financial statements

We agree with the SEC in the aim of capturing the underlying economic reality of transactions and events and we agree with giving management and accountants the responsibility to convey the underlying economic reality to investors. However, we feel that there has to be greater trust between, and among, regulators, standard setters, auditors, users and preparers of financial statements in allowing management to exercise judgement in presenting that economic reality. We have had particular regard to the challenge of setting principles that can be applied across national boundaries and across diversities of culture where there must be sufficient scope in interpretation of the principles to allow the economic reality to emerge.

How did the Rules-based Approach Emerge?

It has been suggested to us that the rules-based approach developed in the US results from a history of rigorous and aggressive regulation of financial reporting. This led to a spiralling development because each success on the part of the regulators increased the propensity to create even more rules.

We understand that the regulatory appetite for rules was significantly driven by a desire for comparability. This is highly relevant to the current debate. The key point is that the more comparability required, the more rules have to be put in place to enforce it. There is thus a natural tension between the desire for comparability and the quest for a principles-based system. In our view, it is necessary to recognise that complete comparability is never possible in accounting. Instead, more emphasis needs to be placed on explaining the key judgements made by preparers of financial statements. This is critical to effective communication in financial reporting and is a point to which we return.

As litigation against audit firms increased in scale the audit firms looked to the standard setters for 'bright-line' rules that could support audit opinions. There was also pressure from clients who wanted definitive accounting information to support merger activity, managerial bonuses and share prices. Chief Executive Officers, as well as Chief Financial Officers, became more interested in accounting and increasingly offered the challenge *"Show me a rule that says I can't do this"*. The emergence of the US Financial Accounting Standards Board as a full-time standard-setting body with a dedicated support staff may also have been a factor, where growth in staff numbers led to growth in work which then generated further growth in staff numbers, and so on.

The Role of Judgement

We recognise that focusing on principles, supported only by the guidance necessary to make the standard operational, places a significant obligation on preparers and auditors of financial statements to exercise professional judgement and it requires regulators and users of financial statements to weigh the benefits of fair presentation, or a true and fair view, against the risks. We believe that the risks are greatly reduced if there is adequate disclosure of the basis on which judgements have been made and that market forces will recognise the quality of that disclosure in making transparent the judgements made.

Market forces will recognise the quality of disclosure in making transparent the judgements made

From our interview discussions we noted some concerns that judgements might not be as easily defensible in litigation and that a requirement for judgements might be too demanding on preparers and auditors. We feel that to accept such views would call into question the nature of a profession. Professional bodies should already be providing the training, ethical and professional guidance to ensure that their members have the ability and the integrity to make such judgements. There has been a significant increase in oversight mechanisms where independent observers evaluate the professional bodies. It seems reasonable to expect that increased governance standards within and around the profession are encouraging increased quality and reliability of professional judgement.

Practical Application

We discussed practical application in detail in our financial instruments workshops. The hedging of financial risk provides an instructive example.

In accounting for such activity, a guiding principle might be that the performance statement should reflect the reduction of volatility achieved economically by the hedge. Intuitively, if a company has mitigated the volatility effects of a particular risk - foreign exchange for example - it makes sense that this reduction in volatility should flow through to the performance statement in the form of a neutral profit and loss impact (or something which is close to neutral depending on the efficacy of the hedge).

It is interesting to note that IAS 39 does not embody such a principle. Rather, there are complex rules which determine whether or not it is acceptable to flow the impact of the hedge and hedged item through the profit and loss account in the same period. And, because the rules include onerous documentation and effectiveness testing requirements, profit and loss neutrality is an outcome which is effectively optional. In other words, if the hedge is not documented and/or the effectiveness tests are not performed, hedge accounting cannot be applied. As a result, it is perfectly possible for the performance statement to exhibit volatility even though economically a company may be perfectly hedged. To many, this is a perverse outcome and illustrates the importance of establishing a hierarchy in which the higher-level principles carry more weight than the lower-level guidance.

More specifically, we believe that principles-based accounting requires a clear hierarchy of overarching concepts, principles that reflect the overarching concepts and limited further guidance. The additional guidance should be restricted to brief explanation built into the standards themselves, as well as a small number of interpretations on major issues.

Principles-based accounting requires a clear hierarchy of overarching concepts, principles that reflect the overarching concepts and limited further guidance

Our interviewees and workshop participants also acknowledged that in practice it is impossible to have principles without at least some additional guidance. We agree with the view that this further guidance should be minimal: there should only be as much as is necessary to make the principles and accounting standard operational. In such a system we believe that higher-level principles should take precedence over lower-level guidance where necessary to reach a 'true and fair' view and to reflect the economic reality of a transaction.

Our recommendations:

- We support the consensus that only principles-based accounting standards can fully serve both the needs of business and the public interest.
- It is necessary to recognise that complete comparability is never possible in accounting. More emphasis needs to be placed on explaining the key judgements made by preparers of financial statements. This is critical to effective communication in financial reporting.
- Principles-based accounting requires a clear hierarchy of overarching concepts, principles that reflect the overarching concepts and limited further guidance. The additional guidance should be restricted to brief explanation built into the standards themselves, as well as a small number of interpretations on major issues.

WHY RULES ARE NOT THE ANSWER

One interesting feature of our investigations was to collect the arguments for and against rules-based standards. We found that some reasons could be used to argue the case either way. It became apparent at an early stage of our investigations that rejecting rules-based standards was the starting point for some commentators. Finding an alternative approach in principles was, for some, the second stage. We wanted to be sure that in advocating principles-based standards we were not merely joining an 'anti-rules' campaign. However, we did not find any sustainable argument supporting rules-based standards. In this section we present the conflicting views that we discovered, followed by our evaluation.

> **FOR RULES:** *Rules-based standards are what the participants (preparers, auditors and regulators) want. Rules-based standards provide detailed guidance and clarification and precise answers to questions.*
>
> **AGAINST RULES:** *Rules-based standards reduce or eliminate the exercise of professional judgement and lead to de-skilling of the profession.*

We believe that participants, particularly in the US, have initially been conditioned to rules through the process of education and training and have then continued to look for the rule as the starting point in answering a problem. When exposure drafts are issued there are requests to standard setters for more explanation or more detailed information. We note that in the UK the experience of FRS 5 *Reporting the substance of transactions* has shown that judgement-based accounting can operate successfully to report economic reality in a situation where previously there had been over-reliance on rules governing legal form.

Those applying the rule may feel that they have a precise answer but there is no guarantee that precision means fair presentation. Comfort is drawn from mechanistic application of the detail rather than standing back to make a professional judgement on the overall picture.

> **FOR RULES:** *Rules-based standards are authoritative and enforceable.*
>
> **AGAINST RULES:** *Rules-based standards do not prevent dishonest practice.*

Authority and enforcement are qualities of regulators, not of the words in the rules. A regulator can be equally, or more, challenging of judgement in requiring justification. Regulators must have the capacity to understand and question the judgement on the basis of stated principles, rather than seeking refuge in rules designed to ease operation of the regulatory process.

However, we believe that neither rules-based standards nor principles-based standards can prevent dishonest practice.

> **FOR RULES:** *Rules-based standards provide greater comparability.*
>
> **AGAINST RULES:** *Rules-based standards do not guarantee comparability.*

Comparability has come to mean 'all the same'. However, we believe financial statements should be capable of comparison when the economic reality of similar transactions and events are understood in a similar way by the users of those financial statements. The disclosure by the preparer of judgements made is key to that understanding.

> **FOR RULES:** *The complexity of rules-based standards is only a consequence of the complexity of the underlying business.*
>
> **AGAINST RULES:** *Rules-based standards cause complexity and delay in keeping abreast of change.*

We take the view that reacting to complexity by creating rules is an example of chasing a problem after it has occurred. We expect that a well-defined set of principles will provide the framework for dealing with complexity as it arises, retaining a strong focus on representing the economic reality.

> **FOR RULES:** *Rules-based standards offer equal access to emerging opinions.*
>
> **AGAINST RULES:** *Rules-based standards can never be comprehensive.*

We do not expect a system of principles-based standards to remain static. Discussion of the principles will bring out emerging opinions and we would expect the participants (auditors, preparers, users and regulators) to engage proactively in the debate. The mechanisms for sharing those opinions are not determined by the nature of the accounting standards.

> **FOR RULES:** *Rules-based standards deter creative accounting.*
>
> **AGAINST RULES:** *Rules-based standards foster creative accounting by diverting judgement from economic reality to the detail of application.*

We feel that there are sufficient recent examples of creative accounting under rules-based regimes to make it unnecessary to quote specific cases. Interviewees said to us that rules create a road-map for avoidance and divert attention from the need for fair presentation or a true and fair view.

> **FOR RULES:** *Rules-based standards set out greater detail, which is especially important where translation is needed.*
>
> **AGAINST RULES:** *Greater detail in rules requires to be translated, with correspondingly greater difficulties.*

We recognise that there is a need for considerable technical guidance in countries where principles-based standards are a new idea and there has been a custom of relying on statutory regulation and strong governmental guidance. However, we do not believe that accounting standards themselves have an educative role. We expect that professional bodies and professional accountancy firms in those countries that have developed principles-based approaches to accounting will be willing to provide support and guidance in the transition. We also recognise that accounting standards written in English may contain wording that does not translate well but we see this as an issue for a terminology discussion rather than a factor requiring rules-based standards.

WHY RULES ARE NOT THE ANSWER (Continued)

Issues Arising

Rules-based accounting systems establish a series of 'bright lines' that allow people to 'play the system' at the expense of the relevant principle. 'Bright lines' are, for example, fixed percentages within standards that are used as a surrogate for a broader assessment of an issue, thereby taking away any element of judgement. We agree with our interviewees and workshop participants that it is impossible to cover every eventuality where standards are built upon such prescription. Furthermore, prescription opens up the risk of financial engineering and creative accounting.

In a rules-based approach the rules often become very detailed, with standards approaching hundreds of pages. This results in great complexity and encourages users to focus on the letter, rather than the spirit, of the standard. Rules-based systems also drive requests for greater detail which arise because both preparers and auditors want to minimise the risk of lawsuits. This appears to be driven by a belief that rules, if followed, exempt preparers from sanction.

We heard from many that more detailed rules have also arisen because of the inclusion of anti-abuse provisions. They feel that some standards are based on the underlying premise that Finance Directors or Chief Financial Officers cannot be trusted and need to be policed. We are supportive of the view that anti-abuse provisions should be part of the role of wider governance and regulatory systems, not accounting standard setters.

We also agree with the concerns expressed that a rules-based regime risks de-skilling the profession by requiring a 'tick-box' mentality, at the expense of judgement and a real understanding of the business and that this 'tick-box' approach risks affecting the recruitment and retention of good quality partners and staff. The profession may need structural changes in certain countries to avoid creating armies of technicians and bookkeepers, with insufficient capacity for judgement.

"The trend towards 'tick box' will result in good people leaving the profession. We will breed people who like ticking boxes" (an interviewee).

Rules-based accounting allows people to 'play the system'

A view was expressed that most audit failures arose through lack of judgement rather than non-compliance with rules. We recognise the view that rules often provide a vehicle for circumventing the intention of a standard. However, we also heard the view that principles-only standards may present enforcement difficulties because they provide insufficient structure as a basis for ensuring 'compliance'.

We are aware that US GAAP has been characterised as a rules-based approach compared to principles-based International Financial Reporting Standards (IFRS). We have also heard the view that US GAAP is principles-based, but the rules have grown over a number of years due to the demands of preparers and auditors for implementation guidance and the demands from regulators for consistency. Some would say that the rules have taken over from the principles. We are concerned that the demand for implementation guidance and rules under IFRS may also increase as IFRS usage becomes more widespread and more detail is called for.

"IFRS will look like US GAAP in 40 years"
(a US interviewee).

We believe that well-articulated principles leave far less scope for people to convince themselves that an 'inappropriate' interpretation is acceptable. The clearer the principle the harder it is to avoid. Therefore, additional rules to ensure compliance are not required.

There must be fundamental directional change if financial reporting is truly to meet the needs of today's capital markets.

The Answer lies in Principles

Our belief is that rules-based accounting systems foster creative accounting, create complexity and struggle to cope with financial innovation. Such systems can never be comprehensive, do not guarantee comparability and cannot prevent dishonest practice. Further, it is delusory to think that rules can totally eliminate the need for judgement. Complex transactions with unique fact patterns will always require judgement to be exercised. Despite what may be claimed, we believe that rules-based systems cannot eliminate the risk of litigation.

Principles-based accounting systems, on the other hand, can provide a framework within which the economic substance of transactions can be faithfully represented. Such a framework is better able to support meaningful and effective communication with stakeholders and is better placed to do this in a complex and changing environment. The risk of litigation remains present but we take the view that there are ways in which such risk can be minimised.

For all the above reasons, the Working Group believes there must be fundamental directional change if financial reporting is truly to meet the needs of today's capital markets.

"To see what is right, and not do it, is want of courage, or of principle"
(Confucius, Analects, 5th Century BC).

We will now explore further implications of our principles-based approach.

Our recommendations:

- Rules-based accounting adds unnecessary complexity, encourages financial engineering and does not necessarily lead to a 'true and fair view' or a 'fair presentation'.
- Principles-based accounting provides a comprehensive basis for the preparation of financial statements that has the flexibility to deal with new and different situations as they arise and leaves far less scope for people to convince themselves that an 'inappropriate' interpretation is acceptable.

AN ACCOUNTING PROFESSION TO SERVE THE PUBLIC INTEREST

A strong independent auditing profession which is capable of making judgements and standing up to clients is essential. We believe this is clearly in the public interest and would help the accounting profession regain the confidence of investors. A move to a principles-based system should help to retain and recruit good quality audit staff that are prepared to take individual responsibility and act in an independent and ethical manner. However, we accept that a change in the behaviour of participants in the financial accounting and reporting process is also necessary. We agree with the view expressed to us that preparers and auditors need to apply professional judgement in more circumstances, while regulators, users and other stakeholders need to accept the consequences of the use of professional judgement, including some divergence in practice.

A strong independent auditing profession is needed

> *"If preparing accounts does not require judgement, computers could prepare accounts"* (an interviewee)

We identified a view that younger accountants, and accountants in countries where rules-based systems have been prevalent, may lack experience in applying the judgement necessary under a principles-based system. Therefore, we agree that education and training of both current and future professionals needs to be addressed. Educators and professional bodies will need to consider how they teach accounting students to make these judgements. 'Work-based' training will need to be strengthened through the example set by strong role models who defend their judgement to clients, thus instilling the necessary judgemental skills in trainees. The need for ethical training and the knowledge of a client's business are also needed to enable sensible judgements to be made.

> *"There is a danger that, if we move into a rules-based system, we would lose the ability to apply judgement. This is already happening - you will not be able to apply judgement. The skill of applying judgement will be lost"* (an interviewee).

We noted that the fear of lawsuits and second guessing by regulators has resulted in preparers and auditors requesting more rules and being reluctant to exercise their judgement. The threat of a firm's collapse because of one mistake has been seen as an impediment to exercising the necessary judgement under a principles-based system. We are, however, concerned that a rules-based approach makes it difficult for preparers and auditors to comprehend the volume of rules and constant changes.

> *"Einstein himself could not apply US GAAP, as it is too voluminous to comprehend"* (an interviewee).

Our discussions identified the importance of the documentation of key judgements in the financial statements, and audit working papers. This should provide some protection from lawsuits against preparers and auditors and from second guessing by users and regulators. We consider that such disclosure in the financial statements will allow users and regulators to assess the judgements made and their financial impact.

Throughout our discussions we came back repeatedly to the position that there is one accounting principle that encompasses all others – the requirement that the financial statements should convey a true and fair view (or should 'present fairly'). We are aware of the opinion that the application of IFRS, with additional disclosures where necessary, is presumed to result in financial statements that achieve a fair presentation. However, we believe that this presumption risks discouraging preparers of financial statements from giving specific consideration to the need to ask themselves the question: 'Do these financial statements present a true and fair view?' We are concerned that the recommended wording of the unqualified audit report for listed UK groups now links the true and fair view to compliance with IFRSs in the wording: *"the group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union".*

There is one accounting principle that encompasses all others – the requirement that the financial statements should convey a true and fair view

We think the principles-based approach could be emphasised by separating the opinion into "*give a true and fair view and accord with IFRSs as adopted …*". This would link more closely to the previous format of audit opinion in the UK.

We are also aware that while a typical US audit opinion links "*present fairly … in conformity with accounting principles generally accepted in the United States of America*", the affirmation provided by the Chief Executive Officer in response to the Sarbanes-Oxley Act of 2002 is worded without linking fair presentation to a specific set of GAAP. "*Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report*".

Our recommendations:

- Our vision of principles-based standard setting will require a change in the global profession, with both preparers and auditors assuming more responsibility for their judgements and seeking less in the way of detailed guidance.
- In order to implement these changes the training of both current and future professionals will need to be addressed to ensure that accountants have the expertise, and the courage, to make sound and ethical judgements in the overriding interest of a true and fair view. To support this approach, the judgements made need to be documented and disclosed.

RESPONSIBLE ENFORCEMENT

We support the consensus of opinion among interviewees and the workshop participants that accounting standards should not contain anti-abuse provisions. We think that this role lies with regulators.

> *"There is no place for anti-abuse provisions in accounting standards. The role of standard setters is to set the principles, not to enforce them"* (an interviewee).

Under a principles-based framework, we agree that regulators must be willing to accept a range of judgement-based outcomes such that standard setters do not have to give detailed 'implementation guidance' to ensure that standards are applied in an absolutely consistent manner. We support the view that the role of standard setters is to establish and apply the principles, but not to enforce them. The act of enforcement is an issue for national regulators although it is recognised that a body such as the SEC may have an influence beyond its national borders. Co-ordinating committees, such as the Committee of European Securities Regulators (CESR), are also establishing a wider influence.

We consider the role of regulators is crucial as they will have to accept and support the judgement-based approach of preparers and auditors. It is acknowledged that regulators are likely to expect comparability in the treatment of significant accounting items, but for a principles-based system to operate effectively they will have to accept a range of judgement-based outcomes.

> *"Regulators have to accept that answers will not always be precise but that a range of judgement-based outcomes are acceptable"* (an interviewee).

Our discussions led us to believe that principles-based standards will require support from some interpretations. Care will be especially needed to avoid poorly worded or ambigious standards. There is a view that the pressure for interpretations has come from auditors who, in turn, are under pressure to interpret standards in their clients' favour, and also from regulators who believe they can enforce rules more easily. We support the view that the International Financial Reporting Interpretations Committee (IFRIC) should be the first source of interpretation for international accounting standards but we envisage that regulators will also play a role. However, we are concerned that principles-based standards should not become confused by a multiplicity of interpretations and we would not want to see due process curtailed by undue haste to respond to a problem. It has been suggested to us that the period of consultation and deliberation involved in IFRIC's process will not be acceptable to preparers seeking guidance on which to base their financial statements. Our response is that in a principles-based system the preparers have to take the initiative and explain their approach, rather than wait for others to determine the approach. It was suggested to us that a databank of interpretation

The role of regulators is crucial in accepting and supporting a judgement-based approach cases and regulators' decisions could be set up by an independent panel to inform auditors and preparers. We can see an attraction in sharing good practice, provided that the context of each interpretation or decision is sufficiently explicit. However, we think it is also important to have regard to the discipline imposed by market forces and we agree with an interviewee who said that a company that was seen to misapply the principles would rightly be marked down by investors and by commentators.

Our discussions considered how the use of interpretations could be distinguished from a rules-based approach. We heard the view that under a rules-based approach, standard setters try to envisage in advance which problems may arise as a result of the standards, by recognising and seeking to minimise the diversity of approaches that would otherwise be possible under principles-based standards.

Second-guessing problems in advance creates an ineffective form of regulation

Our reaction to this view is that second-guessing problems in advance creates an ineffective form of regulation. It creates a spiral in which the regulator anticipates a problem and suggests a solution; the preparer applies that solution regardless of how closely the facts of the case resemble the supposed problem; and the regulator announces with satisfaction that the solution is widely applied and is, therefore, highly effective. No-one applies the reality check of asking 'has the preparer given a fair presentation of the transaction or event?'

From our reading we are aware of a concern on the part of some regulators that there may be insufficient control over decisions regarding interpretations of the standards. They fear that, with the same or similar standards being used in so many jurisdictions, there is the possibility that different regulators will have different views on the correct application of a standard. They view that type of situation as being detrimental to the efficient operation of capital markets and undoing some of the apparent gains from convergence in standards. One response of the regulators is to develop processes that encourage consultation amongst regulators, thereby reducing the chances for multiple interpretations. In our view the benefits of principles-based standards are unlikely to be realised in a closed circle of communication that is confined to regulators. While it is important that the regulators maintain channels of communication, it is essential that they engage with all stakeholders in understanding the perceptions of how a principles-based system of standards can be rendered effective.

Our recommendations:

- Responsible enforcement of accounting standards requires regulators to be willing to accept a range of judgement-based outcomes. Regulators need to be able to trust preparers and auditors, who in turn must be capable of exercising judgement. One corollary is that anti-abuse provisions and 'bright lines' should not be included in accounting standards.
- A single interpretative body should focus on significant issues rather than detailed matters. Detailed matters should be left to the judgement of preparers and auditors with clear disclosure of how that judgment has been exercised.

CONVERGENCE, ENVIRONMENT AND CULTURE

A surprising degree of unanimity emerged from our discussions that whilst harmonisation to a single set of accounting standards worldwide is desirable, it may not be necessary or achievable in the short-term to medium-term. First, there should be a sufficient degree of convergence such that accounting standards can be regarded as equivalent[1]. Support was expressed for the agreement between the European Commission and the SEC under which the current requirement for a reconciliation of IFRS accounts to US GAAP will be removed between 2007 and 2009. We heard the view that Europe was being brought into the IFRS regime too quickly, without a proper debate and it was put to us that a 'standstill' period could usefully consolidate what has already been achieved to date, correct initial mistakes, ensure consistent application, and allow time for the development of a framework for smaller or unlisted companies.

High quality principles-based standards should take precedence over the speed of convergence

We believe that a principles-based framework should be the basis for convergence, ensuring sufficient consistency of accounting treatments so that the accounting standards and financial statements in different jurisdictions are equivalent – not identical in all detailed respects, but consistent at the level of principles and in their general application. We support the view that high quality standards should take precedence over the speed of convergence.

> *"The key question is: are we converging on better standards"* (an interviewee).

In rolling out a principles-based accounting framework across the world, we accept there will be a need to re-educate those who have known nothing else other than working in a rules-based, often tax-oriented, accounting environment.

We recognise that sovereignty is an issue, with politicians having to agree to give up their sovereignty over accounting standards in favour of an international but essentially private sector, body. Decisions have yet to be taken in many countries on the extent to which IFRS will be accepted or required and this may also depend upon the model that the International Accounting Standards Board (IASB) develops for unlisted/ smaller entities. Whether the IASB follows a more flexible principles-based course may influence these decisions.

> *"Convergence to me means mutual respect and mutal recognition"* (an interviewee).

Our discussions identified the view that the language of standards is also an important aspect in relation to convergence, with the clarity of wording and the quality of translation being paramount. With different meanings and different interpretations possible in different cultures and countries, and coded meanings in particular countries, a full understanding of the principles is vital. We agree that problems with translation would be hugely magnified under a rules-driven approach, for example, the

[1] We use the term 'equivalent' in the general sense of the word rather than with any specific meaning.

banking conglomerates' translation of IAS 39 into different languages. A common agreement on an international language will, therefore, be needed if we are to achieve complete harmonisation.

> *"Language is important. There can be different meanings and interpretations in different countries and cultures. However, this does not necessitate rules - it necessitates greater consistency of interpretation and understanding of the principles, even to the degree that all countries may ultimately have to accept accounting standards written in one language"* (an interviewee).

Problems with translation would be hugely magnified under a rules-driven approach

Previous research on the application of cultural dimensions to accounting has resulted in the perceptions of the UK and US being classified as 'Anglo', with a preference for professionalism, flexibility, optimism and transparency[2]. By contrast, in continental Europe, the traditional perception has been of preferences for secrecy, uniformity and statutory control. Whilst these classifications may be debateable, we think they provide an interesting background to the consideration of approaches to accounting. Three different approaches were identified by interviewees: accounting requirements in continental Europe based on law; UK principles-based standards; and very detailed standards in the US. Despite the perception in the rest of the world that US GAAP is very rules driven, the US interviewees strongly believed that US GAAP was principles based but the detail has built up over the years. In this respect each accounting framework must be regarded as dynamic and any state of equilibrium between principles and detailed rules as very fragile.

Our recommendation:

- Convergence cannot be achieved if the basis for convergence is a detailed rules-driven approach as this will be difficult to roll out across the different jurisdictions and cultures around the world.

2 Gray, S J (1988), *Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally*, Abacus, Vol.29(2), pp.131-148.

APPENDICES

APPENDIX I

FINANCIAL INSTRUMENT WORKSHOP PARTICIPANTS

IAS 39 'Deconstruct' Workshop Participants

Alex Brougham	European Head of Accounting Policy, Morgan Stanley (Chairman)
Hugh Shields	Director and Head of Financial Reporting, Barclays Capital (Facilitator)
Kumar Dasgupta	Associate Director, Technical Accounting Group, Barclays Capital
Martin O'Donovan	Technical Officer, The Association of Corporate Treasurers
Andrew Spooner	Director, Deloitte
Sandra Thompson	Director, Global Accounting Consulting Services, PricewaterhouseCoopers
Sam Wilkins	Manager of Treasury Accounting and Control, ScottishPower

Financial Instruments 'Blank Sheet' Workshop Participants

Marjorie Marker	Managing Director, Corporate Risk Management & Derivatives, Barclays Capital (Chairman)
Hugh Shields	Director and Head of Financial Reporting, Barclays Capital (Facilitator)
Mark Kirkland	Senior Vice President, Global Head of Financial Risk & Cash Services, Philips
Louise McSweeney	Head of Client Accounting, Technical Accounting Group, Barclays Capital
Colin Martin	Director, Financial Management, Financial Services Advisory, KPMG
Gary Romain	UK Head of Technical Accounting, Barclays Capital
Shannon Warren	Managing Director, Accounting Policy, JPMorgan Chase & Co.
Chris Weidler	Head of US GAAP Accounting, Technical Accounting Group, Barclays Capital
Paul Wilkinson	Group Treasurer, Tomkins Plc

APPENDIX II

LIST OF INTERVIEWEES AND INTERVIEW THEMES

Interviewees	Position at time of Interview
Phil Ameen	Vice-President and Comptroller, General Electric Company, USA
Professor David Boymal	Chairman, Australian Accounting Standards Board, Australia
Patrick de Cambourg	President and Chief Executive Officer, Mazars, France
David Damant	Chairman, IAASB Consultative Advisory Group
Hans van Damme	Chairman, Financial Reporting Policy Group, FEE and Partner, KPMG, Amsterdam
Samuel A DiPiazza Jr	Chief Executive Officer, Pricewaterhouse Coopers LLP, USA
Douglas Flint	Group Finance Director, HSBC holdings plc, UK
Robert H Herz	Chairman, Financial Accounting Standards Board, USA
David Holman	Partner and Head of the National Office, Ernst & Young, USA
Michael Hughes	Global Head of Audit, KPMG, UK
Charlie McCreevy[1]	European Commissioner for Internal Market and Services, European Commission
Donald Nicolaisen	Chief Accountant, US Securities and Exchange Commission, USA
Ulf Linder	Deputy Head of Accounting Unit, Internal Market DG, European Commission
Dr Helmut Perlet	Mitglied des Vorstands, Allianz AG, Germany
Joseph L Sclafani	Controller and Executive Vice President, JP Morgan Chase & Co, USA
Andrew Sheng	Chairman, Hong Kong Securities and Futures Commission, Hong Kong
Jonathan Symonds	Chief Financial Officer, AstraZeneca PLC and Chairman of the Hundred Group, UK
Angus Thomson	Technical Director, Australian Accounting Standards Board, Australia
Jürgen Tiedje	Head of Auditing Unit, Internal Market DG, European Commission
Sir David Tweedie	Chairman, International Accounting Standards Board
Ken Wild	Global IFRS Leader Deloitte Touche Tohmatsu, UK

[1] Contribution limited to written comments on international convergence theme.

Interview Themes

Principles versus Rules

- What do you believe is the difference between principles-based and rules-based accounting standard setting? Do you believe that one approach is superior to the other?
- Here are two examples to help us clarify what you mean when talking about a principle:
  - If the accounting principle relating to derecognition of financial assets is that 'derecognition should take place when substantially all the risks and rewards of ownership have been transferred to another party', is that statement of principle sufficient or do you believe that more explanatory information is required, *eg*. the definition of 'risks and rewards of ownership' or 'another party', what is meant by 'transfer' and whether this concept applies to all assets or just a subsection? Please explain your rationale.
  - What accounting principle would you apply to the derecognition of a fixed asset? Is that sufficient in itself or do you need further definitions or explanations to support it? If so, what?
- In your opinion, what are the key reasons underlying the development of longer, more detailed standards?
- Is it a worthwhile effort to distinguish between principles-based accounting and rules-based accounting?
- Is there an alternative that you prefer? Please describe.

The profession

- Is the accounting profession as currently constituted capable of operating within an environment of principles-based accounting standards?
- If not, what changes would be required to implement a principles-based system?
- How are users of financial statements served by a move to principles-based accounting?
- Do you believe that those who (a) regulate and (b) litigate against the accountancy profession are willing to accept a principles-based approach to accounting?
- How can the auditor deal with being 'second guessed' after making his/her best judgement based on the then available information?

Convergence

- What does international convergence mean to you?
- Do you think your vision of convergence is achievable?
- What will happen if local standards do not 'converge' with international standards?
- What effects do you think will convergence or non-convergence have on cross-border investment flows?
- Can convergence be achieved? *eg.* within the next ten years
- How best can convergence be achieved *ie. via* a rules-based approach or a principles-based approach?

APPENDIX III

DETAIL OF OUR ACTIVITIES

A review of the professional, academic and regulatory literature on the Principles versus Rules debate in international accounting standard setting entitled 'Principles-Based or Rules-Based Accounting Standards? A Question of Judgement' edited by Professor Pauline Weetman is available on the ICAS website at www.icas.org.uk. (Under Technical and Research/Accounting and Auditing/Publications.)

The output from the financial instrument workshop sessions "Principles not Rules: Report on Proceedings of Financial Instrument Workshops" is also available on the ICAS website and includes the following:

- Introduction and Summary
- Deconstructing IAS 39 into Principles – The Thought Process
- Deconstructing IAS 39 into Principles – The Principles Identified
- Developing Principles for Financial Instruments – The Thought Process
- Developing Principles for Financial Instruments – A New Model
- Exceptions to IAS 39 Principles Identified – Extract for Illustrative Purposes

Interviews were conducted with influential figures in the world of accounting as detailed in Appendix II. All interview notes were agreed with the interviewees and remain confidential to the members of the Working Group.