THE RULES EXPLOSION

is it time to move toward principles?

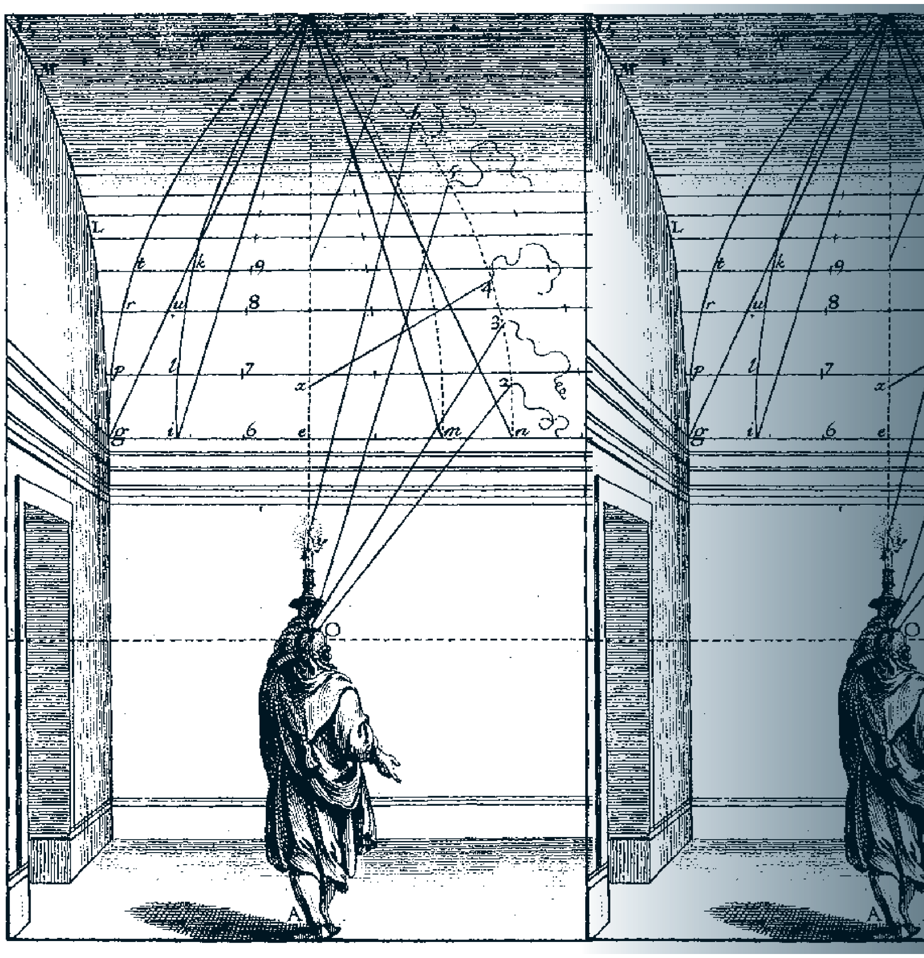
BY LAWRENCE RICHTER QUINN

Grey is good. Indeed, today in U.S. corporate accounting and auditing circles, it promises—or threatens, depending on your point of view—to become all the rage. The issue? How to deal with an accounting standards-setting system that many believe in the aftermath of Enron and all the ensuing debacles—and following billions in market cap loss—has failed investors. It may be time for the black-and-white, rules-based standards system to move aside for a more grey, principles-based one.

The current system has morphed into a Rube Goldberg-type of machine, where an endless plethora of rules, rather than a set of overarching principles understandable to anyone with a basic business and accounting background, dictates accounting treatments. The result? A morally bankrupt standards-setting system that pleases no one.

Here's what experts have to say about the problems with a rules-based system and why it may be time to embrace a principles-based one.

THE PROBLEM WITH RULES



With rules-based accounting, "it's far too easy for corporate executives, accountants, and auditors to lose the forest for the trees," says Michael R. Young, a partner at New York City-based law firm Willkie Farr & Gallagher and author of *Accounting Irregularities and Financial Fraud*. "Executives and accountants have been trapped into adhering to accounting standards that do not capture the overall substance of a transaction.

"What we've seen," Young explains, "is scheming executives putting pressure on their accountants to accept accounting treatments that are not explicitly forbidden. They say or think, 'Show me the rule where it says I cannot do this.' And when the accountants and auditors have no response to that, the CEO gets his or her way."

Adds Mary Keegan, chair of the U.K.'s Accounting Standards Board in London: "A very black-and-white rule doesn't necessarily enable auditors to best debate with management what the right answer is for the capital markets, one that's providing the best financial information. Strong accounting standards are not always produced by a list of rules."

Many auditing practitioners also complain that a focus on rules has locked out discretion and judgment as a crucial and necessary ingredient of the U.S. standards-setting process. Notes Paul Cherry, chair of the Canadian Accounting Standards Board in Toronto: "Today the big accounting firms are afraid of losing a major client if they take a position on an accounting principle or rule that their competitors may not share. At the end of the day they like to give the same advice competitors do so they're not at risk of losing a client."

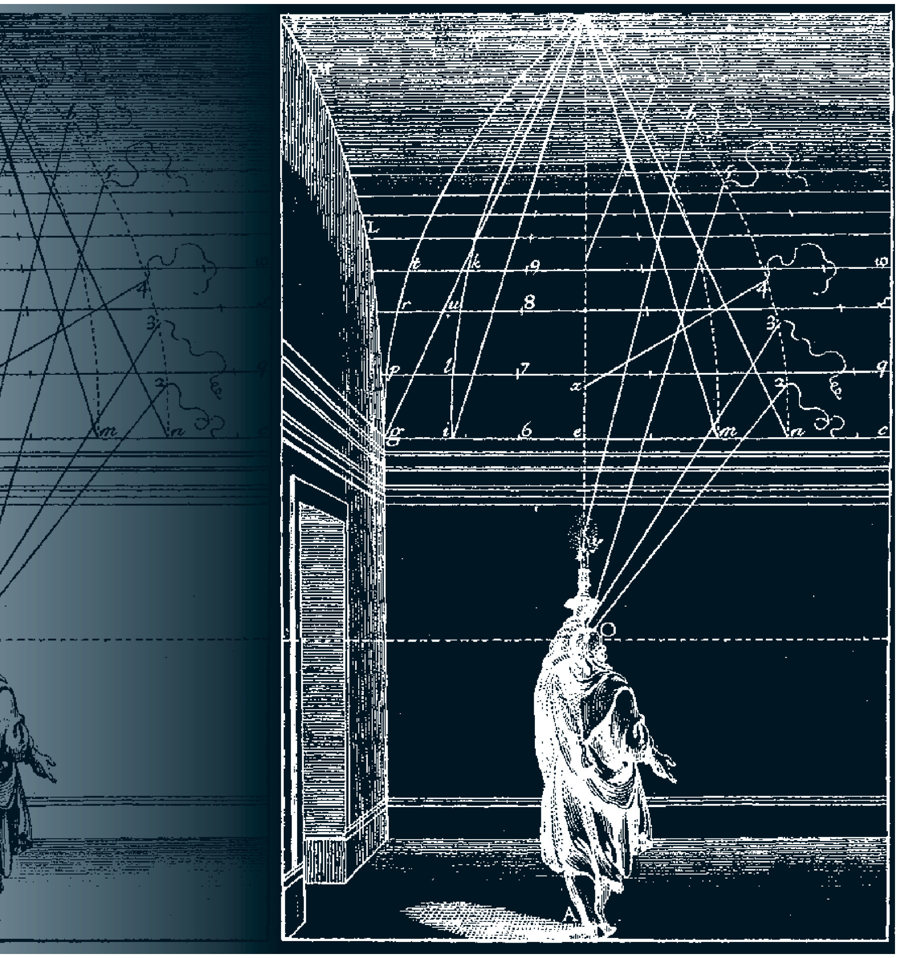
Others say that rapid advances in technology also make being too rules-oriented problematic. "If you overengineer things, you risk getting in the way of progress," says Trish O'Malley, a board member of the International Accounting Standards Board (IASB) in London. This has been a potential problem in the IASB exposure draft regarding stock compensation.

"People keep asking what option pricing model they're supposed to be using. The problem is that the technology has changed dramatically since the original FASB [Financial Accounting Standards Board] standard went out," O'Malley adds. "Now you're able to model things you couldn't a decade ago, so if you specify a model that must be used, you might be getting in the way. In the end, you want to free people to use the best methodology."

The bottom line, however, is that the U.S. accounting standards-setting system is under attack in all corners of the world. "When it comes to U.S. GAAP, a lot of people are thinking that the emperor has no clothes," notes a senior partner at a global accounting firm in London. "It has become a system where people believe that the easier it is to circumvent the rules, the better."

And now even U.S. standards setters and regulators are chiming in. "Rules-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard," Robert K. Herdman, former chief accountant at the Securities & Exchange Commission, testified on Capitol Hill last May. "This encourages a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting.

"And, of course, questions keep coming," he said. "Rules-based standards make it more difficult for prepar-



“A VERY BLACK-AND-WHITE RULE DOESN’T NECESSARILY ENABLE AUDITORS TO BEST DEBATE WITH MANAGEMENT WHAT THE RIGHT ANSWER IS FOR THE CAPITAL MARKETS...”

ers and auditors to step back and evaluate whether the overall impact is consistent with the objectives of the standard.”

THE ROAD TO HELL...

The accounting standards-setting system evolved into its current mess inadvertently and despite the best of intentions. Until the early 1970s, U.S. standards setting revolved around a relatively straightforward set of principles designed to guide accountants and auditors involved in overseeing the numbers-crunching process at publicly held companies. The principles were developed under the auspices of the Accounting Principles Board (APB), launched by the American Institute of Certified Public Accountants (AICPA) in 1959.

Beginning in the late 1960s, a series of accounting scandals erupted, and the birth of “managed” earnings resulted. In effect, overly aggressive CEOs were taking advantage of the broad nature of the APB’s pronouncements and their underlying principles to achieve the financial results they wanted.

Mirroring current events, Congressional hearings were held; the broad nature of the principles-based accounting system was blamed for giving too much leeway to corporate executives trying to achieve the results they wanted. In the end, the APB was put out of its misery, and the Financial Accounting Standards Board was created in 1973 and separated from the AICPA to help ensure the new group’s independence. With “scoundrel proofing” the goal, the FASB began issuing additional rules—what the profession refers to as “guidance”—with each of its pronouncements.

Clearly, the prescription has failed. In recent years, as the FASB has asked for comments on an ever-increasing number of proposed pronouncements, industry practitioners have hit the Board with more and more “what-if” scenarios and questions designed to cover just about every possible corporate accounting scenario. In the process, unfortunately, the underlying pronouncements have been subsumed by an extraordinary explosion in rules and detailed clarifications from the FASB’s Emerging Issues Task Force (EITF).

Says John Wilcox, vice chairman of Georgeson Shareholder Communications, Inc., in New York City: “We’ve drifted over the past decade and lost sight of some of our core principles. And suddenly we’re seeing that our system isn't foolproof."

Former FASB Chairman Dennis R. Beresford adds that even the most responsible accountant just can't keep up. "First of all, it's difficult to figure out just what's there in terms of what publicly held companies are supposed to be doing with accounting," he says. He points out SEC requirements, FASB requirements, and EITF statements, AICPA requirements, and now international requirements to follow. Even if the information is in a database, a very effective search engine is necessary.

Norman D. Marks, vice president of internal audit at Milpitas, Calif.-based Solectron Corp., and former general auditor at Stamford, Conn.-based Tosco Corp., offers the Statement of Financial Accounting Standards (SFAS) No. 133 that governs corporate derivatives use as a prime example of accounting standards setting gone bad that leaves the shareholder behind.

"It never tells you how much income was derived from derivatives over the course of a year. From a balance sheet point of view, it does tell you what the potential liabilities and exposures are," Marks says, "but not how operating results have changed in years past because of derivatives use. Shareholders want to know what the true operating results are, including the impact of products such as these."

THE U.S. SITUATION

In the U.S., lawsuits and cultural issues have helped chip away at a system where the principles are supposed to be clear and easy to understand.

The suit-happy U.S. The number of accounting-related lawsuits naming board chairs, CEOs, and CFOs continues to rise precipitously—and was increasing before Enron's problems came to light. "The reason the U.S. is where it is with its accounting standards-setting problems is the litigious environment it's operating in," says Allister Wilson, senior technical partner and head of the international reporting group at Ernst & Young Global in London.

Adds IASB Board Member Geoff Whittington: "People live in fear of [accounting-related] litigation and damages all the time, so they crave rules."

Just how lawsuit-happy is the U.S.? In 2001, an unprecedented 483 securities-related suits were filed, according to PricewaterhouseCoopers' annual study, which is 225 more than in 1998, when the previous record was set. The majority of the 483 suits involved high-tech companies and IPO allocation cases (where it's charged the IPO'd companies and underwriters received excessive and undisclosed fees from certain investors). Of the non-IPO cases, however, a record 57% included charges of accounting malfeasance. Even more ominously, an increasing number of the IPO cases named board chairs, CEOs, and CFOs as defendants. In 2001, the average settlement totaled $17.2 million—much higher than the average $14.1 million between 1996 and 2000.

Says Charles Laurence, partner in the Pricewaterhouse-Coopers Dispute Analysis and Investigations Practice: "It is clear that no publicly traded company is immune from shareholder litigation. The spotlight is shifting from high-tech companies to all industries. Also, we are seeing more New York Stock Exchange companies and foreign companies being named in lawsuits."

Cultural issues. Much more insidiously, what practitioners outside the U.S. call "cultural issues" in America haven't encouraged independent thinking and a search for accounting treatments that will represent the financial condition of a company fairly. More bluntly, these issues have caused a pursuit of black-and-white answers, discouraging the use of judgment. "What's true and fair?" asks the IASB's Whittington. "That's a question that's very culturally determined."

Notes Trish O'Malley: "With Americans there's this obsession with treating everything the same. But treating everyone equitably doesn't mean treating everyone the same—that is, with consistency. In the U.S., this way of thinking inevitably adds up to more rules.

"When I was in practice I could see this obsession with how the EITF handled questions," she says. "The EITF would put out an issue summary, identifying the problem it was trying to solve, and then it would try to categorize that problem. If you said it was an 'X,' then you knew what rule to apply; if you categorized it as 'Y,' there was another rule.

"So U.S. GAAP applies judgment through trying to determine what bucket something falls into," O'Malley adds. "Then you know the rule, and the rule will give you the answer. Elsewhere in the world practitioners say, 'Here's the transaction, we don't have an answer, what are the anomalies and concepts we can use to come up with an answer?'"

Paul Cherry notes that in the U.S. and, to a lesser extent, Canada, "people seem more obsessed with wanting to prove that a number is right—'This is the only reasonable number'—and that's just not the case."

The upshot of this rules explosion means the underlying principles have been forgotten, shareholders aren't getting easy-to-understand corporate numbers crunching and, ultimately, the short-term needs of special interests take priority over the longer-term need for a system with integrity and honor.

Says a member of the Association for Investment Management and Research (AIMR) in Richmond, Va., which represents analysts: "Substance over form is integral to fair presentation, but that's not what we're getting now with this emphasis on rules. Many of the rules simply are flawed."

The U.K.'s Mary Keegan agrees. "Accountants should look more at substance, less at presentation, but in the U.S. that's not always happening."

So in this Rube Goldberg world, everyone's running for cover. Says Thomas J. Linsmeier, the Russell E. Palmer Endowed Professor of Accounting at Michigan State University and immediate past president of the financial accounting and reporting section of the American Accounting Association: "Business managers want standards that provide the greatest flexibility and room for judgment. They want to be able to manage results yet be able to point to a standard that says that they are following the rules.

"Dealmakers," he explains, "want standards that permit structuring transactions to achieve desired accounting results, with those results potentially obscuring the underlying economics. And auditors are pressured to support standards that their clients like and will not take issue with.

"People are gaming the system using these rules," Linsmeier adds. "They're playing a game."

THE U.S. COMES TO THE TABLE

Following the Enron debacle, the U.S. accounting profession is rushing to restore confidence. In late October, the FASB issued a proposal for public comment on a principles-based approach to accounting standards setting, "which might improve the quality and transparency of financial reporting," a press release from the group says. Comments were due to the FASB on January 3.

"The FASB is committed to improving U.S. financial accounting standards," FASB Chairman Robert Herz says in the release. "Many believe that moving to broader, more principles-based accounting standards such as those used in other parts of the world would facilitate better reporting in the United States. Others, however, are concerned that a principles-based approach could reduce the comparability of financial information and leave too much room for judgment by companies and auditors."

One reason the FASB is pursuing this approach: The recently enacted Sarbanes-Oxley Act requires the SEC to investigate the feasibility of implementing a more principles-based approach to accounting. "The FASB staff worked closely with the SEC in preparing this proposal," the release says.

For some, the FASB's request for comment comes none too soon. "There could hardly be more leeway for abuses than there is now," John Wilcox notes. "I think that's what shareholders would say."

U.S. and other practitioners say that what's needed isn't a system with no rules but one where rules reinforce the underlying principle rather than preempting or rendering it meaningless.

"I think that we may end up emerging with a combination rules- and principles-based approach," says Barbara Franklin, chair of the audit committees at Aetna and Dow Chemical and president and CEO of Washington, D.C.-based Barbara Franklin Enterprises, an international consulting and investing firm. "I think some companies earlier expressed a concern about a more principles-based approach because they thought they might be more easily sued if something went wrong. On the other hand, specific things give people heartburn."

So how do accounting practitioners see this complex blend of rules and principles working? Perhaps impossibly. On the one hand, they want outside auditors and those within companies—internal auditors and accountants—to be able to stand up to senior managers and say: "You can't do this because it doesn't represent the real financial position of a company—it isn't giving shareholders an honest reporting of a company's financial picture." On the other hand, in the U.S., at least, practitioners want to be able to say to senior executives: "Here's a specific rule that says you can't do what you're proposing."

And—perhaps most important—professionals want an even playing field where the presumption is that top corporate executives and everyone in the accounting and auditing professions are being honest.

The IASB's Whittington sums up: "If people are dishonest, any system is vulnerable, including a principles-based one. What is true and fair to a scoundrel? You need good ethics and a good system of governance; these are critical to making sure that people don't stray. You can't afford to be complacent. There are limits to a principles-based approach." ■

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