American Accounting Association's Financial Accounting Standards Committee Response to FASB Invitation to Comment on the FASB Proposal for a New Agenda Project on Issues Related to the Recognition of Revenues and Liabilities

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The Financial Accounting Standards Committee of the American Accounting Association ("the Committee") is charged with responding to requests for comment from standard setters on issues related to financial reporting. The Committee is pleased to respond to the FASB's invitation to comment on the FASB Proposal for a New Agenda Project on Issues Related to the Recognition of Revenues and Liabilities. The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Our response is presented in four sections. The first section summarizes the Committee's views as to the importance and structure of the project. The second section describes the approach that we recommend for proceeding with the project. The third section summarizes relevant academic accounting research findings. The fourth section contains specific responses to the request for comments at the end of the FASB's proposal. In developing the specific responses, the Committee was guided by the discussion in the first three sections.

I. Structure of project on issues related to the recognition of revenues and liabilities

The following comment letter differs from our past comment letters in that the Committee takes this opportunity not only to comment on the proposed project on revenues and liabilities, but also to expand our comments to a more general discussion of standard setting. Our comments support another of the FASB's new projects – that on Codification and Simplification – approved by the Board on January 9, 2002. As part of the codification project, the Board has indicated its intent to evaluate the feasibility of issuing standards based on economic principles and concepts rather than issuing detailed, rule-based standards with exceptions and alternatives. We strongly support the commitment by the FASB to undertake such an evaluation.

The Committee consistently has advocated the promulgation of concepts-based accounting rules. In the past, this support generally has been in response to invitations to comment on specific accounting issues. We believe the Board's current agenda, particularly the new project on codification, provides the opportunity for us to express our support for a shift in the Board's emphasis from rule-based, detailed standards to concepts-based, general standards. Consistent with this view, we believe that the project on revenue and liability recognition is important but that it should be pursued based on the results of the project on codification and simplification. In other words, if the Board's evaluation of the standard setting process results in an adjustment of

its focus to one on concepts, then the revenues and liabilities recognition project should reflect that change in focus.

Furthermore, we believe that an examination of the issues surrounding revenues and liabilities should not be undertaken in isolation but rather as a part of a more general assessment of the underlying philosophy of standard setting for all elements of financial statements. In particular, we do not believe that the linkage between revenues and liabilities is any stronger than the linkage between any other two elements of financial statements and, therefore, that combining the two into a single project is potentially misleading, implying that revenues and liabilities are more interdependent than any other two elements. The evaluation of the feasibility of issuing concepts-based standards must inevitably lead to a reassessment of the rules for recognition of all financial elements, not just of revenues and liabilities.

II. Recommended approach to addressing issues of revenue recognition and liability recognition

The Committee recommends that the FASB rely on fundamental accounting concepts, which are in turn based on economic principles, in determining the appropriate guidelines for the recognition of both revenues and liabilities. Because the economic substance, not the form, of any given transaction or relation should guide the financial reporting, we suggest that the FASB rely on the existing conceptual framework, with appropriate modification thereof, as suggested in the proposed project on revenues and liabilities. We are neither first nor alone in advocating a return to concepts-based standard setting.[1] We also acknowledge that there is no panacea for standard setting issues and that detailed standards with bright lines are not the only, or even the major, cause of currently identified problems in the accounting industry. We recognize that difficult trade-offs exist between bright line and conceptual standards and that the current plethora of rules and regulations has been demand-driven. Concomitant with our recommendation that the FASB (and other standard setting entities) change its focus from the establishment of detailed and specific (sometimes referred to as “bright line” or “cookbook”) standards and move instead toward establishing general standards that guide financial disclosure, we want to stress that such a change in focus explicitly and necessarily requires the application of informed professional judgment and expertise for implementation.

In order to make this discussion more concrete, we first explain the Committee’s view that the accounting standard setting process and its product can be classified along a continuum ranging from unequivocally rigid standards to the provision of general definitions of economics-based concepts. An example of the extreme left (rigid) end of the continuum would be:

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[1] For example, Ralph E. Waters (member, FASB) dissented to SFAS #66 (Accounting for Sales of Real Estate) in 1982 with the following comments:

> “….(Mr. Walters) believes that the accounting profession can serve its members by offering more specific guidance for applying standards in particular specialized areas, but such detailed and arbitrary guidelines should not be dignified as accounting standards. To do so debases accounting standards and inevitably will diminish the stature and effectiveness of the accounting profession, whose strength and purpose arise from applying broad accounting and reporting objectives and standards to specific circumstances with professional judgment and objectivity. That judgment is the hallmark of a true profession.”

> "Annual depreciation expense for all fixed assets is to be 10% of the original cost of the asset until the asset is fully depreciated."

Such a rule leaves no room for judgment in the application of this standard and no room for disagreement about the amount of depreciation expense to be recognized. Comparability and consistency across firms and through time would be virtually assured under such a rule. However, few would support such a standard because it lacks relevance due its inability to reflect the underlying economics of the reporting entity which differ across firms and through time.

At the opposite (right) end of the continuum would be a provision or rule such as the following:

> "Depreciation expense for the reporting period should reflect the decline in the economic value of the asset over the period."[2]

Such a standard requires the application of judgment and expertise by both managers and auditors. The goal is to record economic depreciation of the asset, something about which the manager arguably has more information than anyone else involved. Many might agree that such a rule reflects the underlying purpose of financial reporting but argue that it is too costly to implement and would likely lead to results that are neither comparable across firms nor consistent through time.

The Committee recommends that the FASB set standards that are closer to the far right (conceptual, economics based) of the continuum than to the far left (rigid, bright line, cookbook) for both philosophical and practical reasons. Philosophically, the Committee believes that such rules are consistent with the stated mission of the FASB to "establish and improve standards of financial accounting and reporting for the guidance and education of the public…." Specifically, we believe that conceptual standards, if applied properly, provide greater opportunity for financial information to reflect the economics of the firm, and thus, better support the FASB's stated goal (as part of its Mission Statement) to "improve the usefulness of financial reporting by focusing on primary characteristics of relevance…." Additionally, as educators, we believe that individuals must possess a conceptual framework for financial information in order to use this information appropriately in decision making. This belief is consistent with another of the FASB's stated goals to "improve the common understanding of the nature and purposes of information contained in financial reports." We believe that conceptual standards advance such understanding better than bright line standards.

Practically, evidence abounds that detailed standards are inadequate to the challenges of a complex and rapidly changing financial world and frequently provide a benchmark for determining compliance in form but not in substance (e.g., Finnerty, 1988). The Committee believes it is impracticable, if not impossible, for any standard setting organization to anticipate and provide for every possible form and type of financial transaction and business relationship. Detailed standards are likely to be incomplete or even obsolete by the time they are published.

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[2] By using this example, the Committee is not taking a position about the appropriateness of using "decline in economic value" as a basis for depreciation; this is simply one conceptual approach to depreciation that we use to illustrate points about conceptual standards.

In addition, such detailed standards provide self-interested managers the opportunity to manipulate the reported results under the guise of complying with the rules. In turn, auditors find it more difficult to thwart manager's manipulation of reported financial results when detailed rules serve as the manager's justification. This problem may be exacerbated in the U.S. because U.S. GAAP does not have the equivalent of a "true and fair view" override as does U.K. GAAP, among others, to serve as the basis for reporting economic substance over form.

The Committee offers two examples of problems that we believe a more conceptually based system of guidelines would help alleviate. The first example is accounting for leases. SFAS #13 is a bright line standard with a list of four criteria and the requirement that if any one of the criteria is met, the lease must be accounted for as a capital lease. However, the application of these criteria has been controversial since the promulgation of the standard with hundreds of pages of subsequent documentation dealing with leases (e.g., the FASB's 450 page "*Accounting for Leases – A Codification as of October 1, 1998*"). The G4+1 has issued two special reports on leasing in 1996 and 2000.[3] Both practitioners and academics document that firms restructured their leases to meet the criteria of SFAS #13. For example, Pulliam (1988) documents that third-party guarantors of the residual value of leased assets developed contracts to avoid the 90 percent (present value of minimum lease payments) threshold imposed by SFAS # 13. Imhoff and Thomas (1988) find that many lessees restructured their existing capital leases in response to the adoption of SFAS 13 and that the most common effect of SFAS 13 was the substitution of operating leases for capital leases, presumably in order to avoid liability recognition. Professional expertise, creativity (e.g., synthetic leases) and judgment have been applied to circumvent the accounting rules rather than to present financial statements that reflect the underlying economics of the transaction and of the business entity and that are consistent with the full disclosure goal of the SEC.

The second example is pooling versus purchase accounting for business combinations. APB 16 contained a list of 12 conditions necessary to qualify for pooling, an apparently bright line standard. However, the negative enforcement aspect of this standard resulted in the SEC staff spending an estimated 40% of its time fielding questions on whether specific transaction structures could qualify for pooling treatment. Lys and Vincent (1995) document an extreme case in which AT&T paid as much as $500 million in order to gain SEC approval of the pooling of interests method of accounting for its acquisition of NCR.

In both of the above examples, the Committee believes that conceptually based standards would be more appropriate and effective in accomplishing the goals of financial reporting. The FASC advocated this position in its response to the FASB's request for comment on the 2000 G4+1 lease proposal, maintaining that all leases create assets and liabilities, regardless of the lease's specific terms and conditions. The FASB recently eliminated the pooling of interests method of accounting for business combinations, substituting a required treatment (purchase accounting) and also providing for significant judgment in the application of the new standards for the treatment of acquisition goodwill.

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[3] *Accounting for Leases: A New Approach – Recognition by Lessees of Assets and Liabilities Arising Under Lease Contracts* (1996); *Leases: Implementation of a New Approach* (2000).

The Committee turns to the Internal Revenue Service (IRS) for analogy as to the effects of bright line rules. The IRS relies on the Internal Revenue Code (IRC) and its associated regulations to establish whether or not taxpayers have violated the rules (a negative standard of conduct). There is general consensus among IRC constituents that tax rules have become fearsomely complex, detailed, cumbersome, and costly, as they attempt to restrict transaction structuring that accompanies such bright line rules. Thus, detailed tax regulations facilitate a "form over substance" treatment of an item.[4] We believe the IRS provides a negative example for the FASB, and that accounting standards should mitigate such treatment. Instead, we believe that accounting standard setters should provide guidelines for which there is a positive standard of conduct, relying on substance over form and reflecting underlying economics, rather than compliance with an arbitrary standard. Overall, we believe that the goals of financial reporting are quite different from the goals of tax compliance and that the standards for financial reporting should be structured quite differently from the IRC.

The committee recognizes that conceptual standards provide latitude for managers to choose reporting treatments that do not reflect the underlying economics of a transaction. Managers, audit committee members, and auditors must possess both expert judgment and a desire for unbiased reporting in order for conceptual standards to result in financial reporting that reflects underlying economics. Both the SEC and the Auditing Standards Board support this view with their focus on the quality, as opposed to the acceptability, of financial reporting, and on the need for expert judgment and unbiased reporting (AICPA 1999; SEC 1999).

Finally, we believe that conceptual standards are consistent with one of the stated goals of the FASB, i.e., to promote convergence of accounting standards worldwide. The European Commission is reportedly (Financial Times, February 21, 2002, page 1) proposing that the US abandon GAAP in favor of the "more flexible IAS, which emphasizes 'substance over form' in auditors' inspection of the accounts." Our proposal is consistent with such convergence.

III. Review of related academic accounting literature

The academic accounting literature is somewhat limited with respect to direct research on the issue of conceptual guidelines versus specific or rigid standards for financial reporting. However, there have been several studies that shed light on these issues in various ways and we summarize a representative sample of these below. Because these issues do not lend themselves to empirical-archival research design, most of the academic research to date has been either analytical or experimental-behavioral in nature. Much of the work is related to the auditing of financial statements rather than the setting of accounting standards. The Committee believes that the tension and potential conflict between auditors and their clients are inherently separable from, but not always distinctly different from, the tension and potential conflict between preparers and users of financial statements. Although auditing tensions cannot dictate the form and content of accounting standards, we believe that inferences about standard setting can be drawn from the literature on auditing.

[4] We note, however, that the U.S. Supreme Court has long held the doctrine that "in determining tax liability, taxing authorities must look through form to fact and substance" (Tex-Penn Oil Co., 37-1 USTC ¶ 9194, 300 U.S. 481, 492-3).

The main responsibility for financial reports lies with management, not with the auditor, and the academic literature provides abundant evidence that managers, with or without the knowledge and/or consent of their auditors, structure transactions or relationships to fit within or outside of, as desired, the boundaries of financial accounting rules. There is an extensive empirical/archival accounting literature (e.g., Watts and Zimmerman, 1986) addressing the incentives of managers to make financial reporting choices and decisions in their own best interests. These studies do not provide a comparison of bright line and conceptual standards but rather document evidence of manipulation of financial reporting for both types of standards.

A recent related behavioral study specifically addresses the effects of bright line versus conceptual standards. Based on data gathered from 253 audit partners on their experience with attempted earnings management by their clients, Nelson, Elliott, and Tarpley (2001) find that managers are more likely to attempt earnings management with transaction structuring, and auditors are more likely to waive enforcement, when the accounting is governed by precise standards (e.g., leases, equity vs. cost method, consolidations, etc.) which are amenable to transaction structuring. When transaction structuring is not involved, they find that managers are more likely to manage earnings, and auditors are more likely to waive enforcement, when the accounting is governed by more flexible standards. Judgmental standards are less likely to require transaction structuring because a bright line is needed to structure transactions appropriately. The authors interpret their results as implying that managers will respond to increased precision by structuring transactions more frequently to meet an objective. The authors further conclude that earnings management could be mitigated by reducing the extent of bright line criteria in areas that are amenable to transaction structuring.

Cuccia, Hackenbrack, and Nelson (1995) use experimental methods to determine whether professional tax practitioners are more or less aggressive with vague, verbal standards than they are under more precise, quantitative or numerical standards. The authors find that tax practitioners are equally aggressive under both types of standards but that the form of their aggression varies. That is, with vaguely worded standards, the practitioners use the latitude inherent in the regulation to justify aggressive reporting. With numerical standards, they instead use the latitude available in assessing evidentiary support to justify an aggressive reporting position. The authors conclude that when practitioners have incentives to report aggressively, modifications to standards to make them more stringent and quantitative may prove ineffective in reducing the aggressiveness of the reporting. The Committee recognizes that there are significant differences between tax preparers and auditors and with their respective relations with their clients. Nevertheless, we believe that these results can be extrapolated to the effects of financial accounting standards and that these results support the inferences drawn by Nelson, et al. (2001). That is, we expect that the nature of the accounting standards will alter neither the incentives nor the ability of management to report opportunistically; only the nature and characteristics of the opportunistic reporting will vary depending on the nature of the standard. Issues with managerial incentives must be addressed by means other than promulgation of detailed accounting standards.

Dye (2002) models analytically the manager's financial reporting process as one of classification manipulation. That is, for many standards, there is a generally preferred outcome (e.g., operating

rather than capital lease treatment) and classification manipulation results in more firms attaining the preferred accounting treatment than would otherwise be the case under GAAP. As a result, "the boundary delimiting the more and less favorable classification encoded in a GAAP (or GAAS) standard, will – as a consequence of classifications manipulation – be shifted to a lower threshold, a *shadow standard*, demarking the boundary between those firms who are or are not willing to pay the cost of classification manipulation to secure the more favorable classification." In other words, Dye provides support for Nelson et al.'s (2001) conclusion that rigid standards will increase managers' ability to manipulate financial reporting outcomes opportunistically, and thus weaken the effectiveness of the standard.

In a related empirical study, Engle, Erickson, and Maydew (1999) explore whether managers will incur costs in order to classify a financial transaction as equity rather than debt. Prior empirical research provides evidence that managers structure transactions to avoid balance sheet recognition (e.g., Bowman, 1980 and Ely, 1995 on leases and Shevlin, 1987 on R&D limited partnerships) but Engle, et al. explore balance sheet classification manipulation between debt and equity. The authors find that firms incurred costs of as much as $43 million in order to classify a transaction as equity rather than debt.

Hronsky and Houghton (2001) also test the classification issue using the change in the wording of Australia's standard on extraordinary items – that is, the definition of extraordinary item was changed – and 40 experienced auditors as experimental participants. The regulators changed the definition in order to remove the flexibility inherent in the old definition and thus "limit the inconsistencies and alleged opportunism observed in practice." The authors find significant differences in classification based on the new rules, from which they infer the importance of definitions and interpretations in decision-making. The authors conclude that a change in the regulated definition is perceived as having a different meaning by one important party in the financial reporting process (auditors) and that there is a systematic relationship between the perceived meaning and the subsequent classification decision outcome, in the direction intended by the regulators. This study provides evidence that precision in the wording of conceptual standards may in fact mitigate "aggressive" reporting.

One of the auditor's roles is to monitor management's impulses to act opportunistically in financial reporting. Several academic studies offer indirect support for bright line standards by documenting evidence that rigid GAAP provides the justification needed by the auditor to perform this monitoring function. For example, Trompeter (1994), in an experiment using 54 audit partners as participants, finds evidence that auditors find it more difficult to resist client pressure for aggressive reporting when there is a wider range of acceptable accounting alternatives. Hronsky and Houghton (2001) find that "clearly worded standards provide guidance to auditors in auditor-client conflict situations and reduce the justifiability of aggressive reporting decisions." Knapp (1987) documents that audit committees are more likely to support an auditor in a dispute with management when the issue is covered by technical standards. Magee and Tseng (1990) model the links between audit pricing, auditor independence and the characteristics of accounting standards. They find that when accounting standards are specific, threats by the client to "opinion shop" in the case of a dispute are less effective because it is likely that all auditors will take the same position on an issue.

These studies find that other factors also affect the auditor-client negotiations over GAAP. For example, Trompeter (1994) finds that the auditor's ability to resist client pressures also is affected significantly by the compensation structure of the auditing firm. Nelson, et al. (2001) report that the auditor's decision on whether to waive enforcement when earnings management is apparent is also influenced by the size of the client and the size of the earnings management. Hackenbrack and Nelson (1996) conduct an experiment using experienced auditors in which they conclude that the auditor's incentives (determined by the level of audit risk) influence significantly the interpretation of the applicable accounting standard. They find that when engagement risk is moderate, auditors prefer the aggressive reporting method and aggressively apply the relevant financial accounting standard. When engagement risk is high, the auditors prefer the conservative reporting method and conservatively apply the relevant professional standard.

Thus, the literature supports the view that both managerial and auditor incentives have significant effects on financial reporting decisions. This research provides some evidence that the nature of the governing accounting standard, rigid ("bright line") or flexible is important, but generally a second order effect compared to incentives.

In summary, the Committee concludes that the academic accounting research to date provides limited guidance for standard setters on the issue of flexible versus rigid or bright line standards. The literature generally reports that flexible standards accompany greater conflict and more negotiation efforts between auditor and client (Gibbins, Salterio and Webb 2001). On the other hand, one recent study (Nelson et al. [2001]) finds that the nature of managers' manipulation of standards varies with the nature of the standard (is not precluded by the presence of rigid standards) and that opportunistic manipulation may be reduced by the writing of more flexible standards when managers use transaction structuring to circumvent the accounting rules.

Based on the literature and our experience as educators, the Committee recommends that the FASB focus on setting conceptually-based standards that emphasize the reporting of economic substance over accounting form. We recognize, consistent with evidence in the accounting research literature, that the implementation and enforcement of such accounting standards may be daunting because they necessarily rely on the joint efforts of management, the board of directors, and the auditors to apply professional expertise and judgment to financial reporting. However, the tensions between and among the firms, their auditors, investors, and regulators are not specific to the nature of the standards as bright line or conceptual. Standards, in whatever form, cannot solve these conflicts. We believe that issues of incentives and monitoring should be addressed separately and should not determine the nature of accounting standards.

IV. Responses to questions posed in the proposal for a new agenda topic

The Committee responds below to the request for comments but we do not respond to the "Appendix - Examples of Issues to be Addressed" (with one exception) because we have not found support in the academic accounting literature for the specific questions asked in the appendix. The one exception is question 2 under "Issues Related to Both Revenues and Liabilities."

Request for comments

1. Is there a need for the FASB or others to comprehensively address issues associated with the recognition of revenues and liabilities? If yes, should the FASB take on such an effort or defer to others? If so, to whom?

The Committee believes that there is a need for the FASB to address issues associated with the recognition of both revenues and liabilities and that the FASB is the appropriate organization to undertake a comprehensive review of the issues.

2. Is the proposed scope of such a project as described in this proposal insufficient, appropriate, or too ambitious?

The proposed scope is insufficient in that the Committee believes it is not possible to address recognition issues for revenues and liabilities without simultaneously addressing issues related to other elements of financial reports -- expenses, assets, and equities. We recommend that the overall structure and organization of the accounting standards in the U.S. be reviewed. However, if this project is restricted to just revenues and liabilities then they should be addressed by two separate projects, not a single joint project.

3. Should specific issues identified above or in the appendix be excluded from the scope of the proposed project? If yes, for each specific issue, please indicate whether it should be addressed as part of another FASB project, by others, or not at all and why.

The items that should be excluded from the scope of the proposed project are those in the appendix that are already too detailed and too prescriptive to be accommodated under the rubric of conceptual guidance, economic principles, and reporting of economic substance over form. For example, item 6 under "Issues Primarily Related to Revenues" asks whether revenue recognition should be prohibited if the customer retains the right to return or whether both revenue and a related liability to accept return should be recognized? The Committee anticipates that, given the appropriate definition and set of conceptual criteria for recognizing revenues, that some sets of facts and circumstances would dictate revenue recognition and some would not. This is an excellent example of where the provision of a bright line standard either way provides the basis for manipulation of the financial disclosures.

4. Should specific issues not identified above or in the appendix be addressed as part of the proposed project? If yes, please describe the specific issue and indicate why it is sufficiently crucial that it should be addressed as part of the proposed project.

As described in 2. above, the Committee believes that the underlying concepts for all of the major financial reporting elements should be reviewed and modified.

5. Should the proposed project, in addition to developing a new, general accounting standard on revenue recognition and revising the related guidance on revenues and liabilities in Concepts Statements 5 and 6, develop a new, general accounting standard on liability recognition.

The Committee recommends that the FASB reevaluate the underlying conceptual framework for all elements of financial reporting. Although practicality might dictate the division of effort into more manageable pieces, we advocate a co-coordinated evaluation and treatment of all categories of financial reporting items. While recognizing the relations and interdependencies among financial elements, we do not perceive the link between revenues and liabilities to be stronger than the link between any other two elements and thus do not support the combining of revenues and liabilities into one project without the other elements.

Appendix Question 2 from Issues Related to Both Revenues and Liabilities

2. Are conceptual criteria for recognition needed or would the definitions of the items to be recognized in financial statements be sufficient if those definitions were refined and clarified?

The Committee does not believe that definitions, even if refined and clarified, are sufficient for determining recognition. Conceptual guidelines are needed to guide the judgment process that we recommend. Furthermore, support for the application of professional expertise and judgment *per se* should be provided.

Mason and Gibbins (1991) in discussing the issue of professional judgment, quote from the Canadian *Introduction to Accounting Recommendation:* "…no rule of general application can be phrased to suit all circumstances…that may arise, nor is there any substitute for the exercise of professional judgment in the determination of what constitutes fair presentation or good practice in a particular case." They likewise quote from the U.K.'s *Explanatory Forward to the Statement of Standard Accounting Practice*: "In applying accounting standards, it will be important to have regard to the spirit of and reasoning behind them. They are not intended to be a comprehensive code of rigid rules. They do not supersede the exercise of an informed judgement in determining what constitutes a true and fair view in each circumstance…."

Thus, the Committee proposes that the FASB provide both conceptual guidelines for professional judgment and explicit references to the importance of professional judgment in interpreting and implementing GAAP in the preparation of financial reports.

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