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Deloitte Fireside Chat – Part II:
Principles versus Rules-Based Accounting and Auditing Standards

PATRICIA FAIRFIELD: Good afternoon and welcome to today's Deloitte Fireside Chat Part II, exploring Principles versus Rules-Based Accounting and Auditing Standards, broadcast live on www.sechistorical.org, the virtual museum and archive of the SEC Historical Society. I am Patricia Fairfield, Associate Professor, McDonough School of Business, Georgetown University and moderator for the program.

The Deloitte Fireside Chats, both today's program and Part I broadcast last week on Thursday, October 22nd, are made possible through a partnership between Deloitte LLP and the SEC Historical Society. Deloitte is the brand under which 160,000 dedicated professionals in independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management and tax services to selected clients.

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I am delighted to welcome today Robert J. Kueppers, Deputy CEO, Deloitte LLP and a trustee of the SEC Historical Society; and Scott A. Taub, Managing Director, Financial Reporting Advisors, LLC and former Acting and Deputy Chief Accountant, SEC Office of the Chief Accountant. In our discussion today we will look at such issues as what is meant by principles-based and rules-based accounting standards, what are the characteristics of ideal accounting standards, and how to achieve ideal standards.

Before we begin the program I would like to state that the views of the presenters are their own and do not reflect those of Deloitte LLP or of the SEC Historical Society. The Society is responsible for the selection of the moderator and the presenters. Our discussion today will be guided by questions suggested by the presenters, by a planning team from Deloitte LLP including Lauren Bonn, Consuelo Hitchcock, Misty Jenkins Saldi and Raymond Lewis, and by questions submitted by visitors to www.sechistorical.org prior to the Fireside Chat.

I would like to begin the discussion now with an attempt to try to put this conversation in a little bit of context for people who may not be familiar with some of the issues that we are going to be presenting here. Scott, maybe you could start us off by providing a little bit of historical background to the discussion of principles versus rules. I think we are all well aware of the fact that the intensity of this discussion seems to be increasing and I was wondering if you could give your perspective on why now this discussion seems so much more important than it was 20 or 30 years ago.

SCOTT A. TAUB: Patty, I am happy to do that. This debate has really been going on a long time. I have seen evidence that it pre-dates even my participation in the accounting profession although I personally only got involved in these discussions perhaps eight or nine years ago in earnest. After a speech a couple of years ago a member of the audience brought up to me a weathered textbook with a publication date of 1966; it had a chapter on principles versus rules in accounting standards. So clearly it has been going on for quite a long time. The issue to me at least seems to be becoming more and more important, at least more and more in the past few years, as there has been more and more focus on accounting and financial reporting. The Enron frauds and everything else that happened around that time followed by the Sarbanes-Oxley Act and even now the credit crisis that we have been in for the last year and a half or so have all caused people to look at financial information harder than they ever did. That has put pressure on every part of the financial reporting system, be it issuers, auditors, users of financial statements, regulators and of course standard setters. One of the things that I think comes up as pressure is increased is that there is more and more consideration by those in the system of just how confident they can be that their decisions that their treatments are the right ones and the ones that will be accepted by regulators and by the markets in general. That has shed a light on the fact that there are certain accounting standards that have very detailed rules, detailed lists and there are other accounting standards that do not. Those different kinds of standards provide different levels of comfort to different people as they are doing their accounting. We see that in some instances the fact that there is a detailed list of rules sometimes makes people more comfortable that they are getting their accounting correct. Other times, the rules may cause people to believe they are forced to do accounting that in fact does not best reflect the economics and therefore that doesn't feel right to them. And so, with all of the increased pressure on the system and people looking harder and harder at financial reporting, it just puts more pressure, sheds more light on this issue which has really been kicking around for a long time.

PATRICIA FAIRFIELD: Let me bring up another question that I think comes up all the time. When we discuss principles versus rules, I find it is very rare to encounter someone who says, "I am for rules and I am against principles." That's an unusual stance to take and yet in discussions very often you find there becomes a polarization of views. What is really at stake in these debates and who are the participants and what do people stand to win and what do people stand to lose as we move more towards principles and away from rules?

ROBERT J. KUEPPERS: Let me start that one, Patty, I think that your first point about who you are going to find as opposed to principles probably goes to just a very visceral kind of impression people have. No one wants to admit that they are unprincipled to be sure but what you say is exactly right. The question though is taking it from concept to application and when we could all sit back and use a whiteboard and then come up with a design of a great set of accounting standards. But the reality is that preparers, auditors, investors, regulators, I mean all the elements and the constituents of financial reporting, have perhaps a different need and would like to see the same economic substance portrayed in a way that is most useful and most transparent. I think there's a lot at stake in this debate. One of the issues that comes up all the time is comparability. Maybe if you have principles you will find that folks will choose a different answer all having analyzed a set of principles that apply to their transaction and might come up with a different outcome for an accounting result and therefore we won't have comparability. I actually think the SEC in their study a number of years ago actually hit on this as a sort

of a false positive that comparability is, not that it is over-rated but I think people often use that often as an excuse. It's just one facet of this whole topic: how can you get comparability with principles as an example.

SCOTT A. TAUB: Patty, I think one of the reasons you don't find anybody who says they are against principles in addition to of course it sounds bad as Bob points out. None of us are unprincipled. There is also the issue that even in the accounting standards that have a lot of rules that some people might call rules based, I think in fact the case that those rules are intended to cause a result that is consistent with some underlying set of principles. Without the underlying principles you can't even write a rules-based standard because you wouldn't know what you were trying to make the rules do. And so I think when people call a standard rules-based, what's actually happening is that there are principles underlying the standards so in that respect the standard is principles based. It's just that the standard setters decided over time that the best way to ensure that those principles are followed is to write rules that were intended to cause the accounting to result in accounting consistent with a certain set of principles. Where I think the problem comes is that sometimes those rules in fact don't always succeed in causing accounting that is consistent with the principles.

ROBERT J. KUEPPERS: I want to build on what Scott said. Think about this. If you have an underlying principle but a number of rules and the construction of the standard itself is such that there are numerous exceptions, then you need carve-outs and unique circumstances and tests and that sometimes leads to so-called bright lines or as long as it is below 10% you do this. The exception portion of that in terms of a standard is sort of a self-fulfilling prophecy. If you are willing to provide a lot of exceptions, the complexity of the standard in how it's applied goes up exponentially.

PATRICIA FAIRFIELD: Let's move on to what I find is often a sub-text in the discussion of principles versus rules, which is what very quickly when people are talking of principles versus rules, we find that the context moves to IFRS versus GAAP. I am wondering if you could first comment on whether or not you think this has really been the case and how long has this been the case that these were considered to be equivalent conversations. Also in that context, Scott, I am wondering if, since you were party to some of these particular documents, you could review some of the official documents that have come out. I can list them for you but let's start maybe, Bob, did you want to...?

ROBERT J. KUEPPERS: On your first question, as a surrogate for principles versus rules, should we just be talking about IFRS versus GAAP? That makes me a little nervous, only because now you are dealing with markets versus markets and I will call it the politics of this. I mean, we have got the G20 working on accounting. We have got all kinds of folks in an intense debate about is it U.S. versus the rest of the world, U.S. versus Europe. When you start down that road I think it is a very different discussion than trying to keep it a little higher because it's natural to have to weigh in - one versus the other and which is better- what should we do, which I think we will get to.

PATRICIA FAIRFIELD: We need another Fireside Chat on regulatory bodies.

ROBERT J. KUEPPERS: I think you are right. Scott, maybe you want to talk about some of the seminal events in the current decade on this debate?

SCOTT A. TAUB: I will start out with one that I did have a relatively significant hand in, the study that was issued by the SEC pursuant to the Sarbanes-Oxley Act in 2003. I think it's entitled the adoption by the United States financial reporting system of a principles based accounting system, which sounds very high faluting.

PATRICIA FAIRFIELD: And just for the record, do you want to discuss the impetus for that study?

SCOTT A. TAUB: That study was mandated in the Sarbanes-Oxley Act. There is a section of the Act that required the SEC to do such a study. It really came after the series of financial reporting frauds that were revealed early in this decade. One of the purported causes of such frauds was rules-based accounting standards that fostered a mentality of trying to structure transactions to get certain accounting, while looking to the standards themselves to provide protection from regulators. There were those who believed that if we had a more principles-based system of accounting standards, it would have been harder for companies to actually commit those financial purporting frauds.

PATRICIA FAIRFIELD: Enron would not have happened had we had principles.

SCOTT A. TAUB: I happen to think that's untrue, but there were those who certainly believed that may have been the case. I was SEC Deputy Chief Accountant when we wrote this study and quite frankly I think a lot of what is in that study is almost basic logic that, in order to write a good accounting standard, it has to be grounded in principles. You have to start with principles; you can't simply jump to rules because, as I said earlier, you wouldn't know what you were trying to draft rules to do if you didn't have the principles. But what we went on to talk about in that study was the fact that in order to have a true principles-based accounting system, it isn't just accounting standards that need to be written differently, but in fact those applying the standards need to be thinking differently. There are implications for all parts of the financial reporting system, not just the writer of accounting standards. We could have principles-based standards but if those applying the standards and enforcing the standards were not comfortable with - as Bob alluded to - some diversity in practice, because if you don't have bright line rules you will have diversity of views. So if everybody is not comfortable with that, you are not going to have principles-based application and then the system is going to have troubles, perhaps different troubles than they have in a rules-based system, but troubles nonetheless. We did look even at the time of that study in 2003 at the issue of IFRS versus US GAAP - is IFRS more principles based? The only thing I can say unequivocally is that IFRS is shorter than US GAAP. There are less words; there are less standards. Is it appreciably more principles-based? If you believe that words equals rules, then you would believe IFRS has less rules and therefore perhaps is more principles-based. Quite frankly I think the reason the IASB and the FASB lately have been able to work together on joint projects is because they really do have a similar view of how standards ought to be. It's not like the US favors one kind of standard and the rest of the world a different one. I am not at all convinced that IFRS equals principles-based and US GAAP equals rules.

PATRICIA FAIRFIELD: In the 2003 study, was convergence considered to be an important goal?

SCOTT A. TAUB: Convergence was already considered to be a goal by that time. In fact, the Sarbanes-Oxley Act mentions convergence as something that we ought to

consider and that accountants ought to consider. It wasn't a specific focus of the study necessarily, but it was something that was already on people's minds. The historic Norwalk Agreement between the FASB and IASB was signed in 2002. They were going to work together to eliminate differences to the extent they could and so we were already kind of well on the road to convergence by the time that study was issued.

PATRICIA FAIRFIELD: Just following on from that question I am wondering if either one of you want to comment on where you think we are on the road to adopting either principles-based accounting in the United States or adopting IFRS. I was discussing this with some of my colleagues and one of them mentioned that she had been at a conference with a member of the International Accounting Standards Board who said, "The train has already left the station and we are going to IFRS." I am wondering if you agree with that statement.

ROBERT J. KUEPPERS: I am a little confused because on the one hand, we were on a road and now we are on a track - I am not sure which.

PATRICIA FAIRFIELD: All right.

ROBERT J. KUEPPERS: My views kind of change. I do think that nothing is going to move without the SEC's weighing in on this and I think we have lived through a period of time for reasons I think everybody will understand. Here we are sitting here in October 2009. The last 12 months have been an unbelievable distraction for policy matters and good intentioned agenda items which just by necessity have had to go onto page two instead of being top of mind at the SEC. I think the good news sitting here in October 2009 is that within the last 60 days or so both Mary Schapiro and Jim Kroeker have indicated that they haven't forgotten about IFRS and the road-map and the need to deal with it. I can't predict timing and I think that would be foolish to try. But I see in the year ahead much more discussion and decision around it and I think we are all sitting on the edge of our seat to see where it's going to go, and I am of course speaking about IFRS.

SCOTT A. TAUB: On the move to IFRS I think Bob has just - unintentionally I hope - called me foolish because I have recently predicted timing. I have said in public venues a couple of times in recent months that my prediction at this point is that 2017 will be the time that we first see mandated IFRS by U.S. companies.

PATRICIA FAIRFIELD: That's good. That's on record now.

SCOTT A. TAUB: It has been on record already; that is why I don't mind saying it here.

ROBERT J. KUEPPERS: My son told me the world's going to end in 2012.

SCOTT A. TAUB: You have been watching too many movie previews.

ROBERT J. KUEPPERS: That's right.

SCOTT A. TAUB: I think we will go to IFRS, but by no means do I think it's inevitable. There's a lot of work that needs to be done but I do think that work will be done. I don't think that moving to IFRS as I had alluded to before equals moving to more principles-based standards.

PATRICIA FAIRFIELD: Say that one more time.

SCOTT A. TAUB: I don't believe that moving to IFRS means definitively that we are moving to more principles-based standards because I don't necessarily believe that IFRS are more principles-based than U.S. GAAP. I know that those writing IFRS often say we are writing a principles-based standard, but I think that's everybody's intention to write a principles-based standard. You never intend to write a standard that is unprincipled.

ROBERT J. KUEPPERS: But you are on record earlier in this conversation saying that at least they are shorter.

SCOTT A. TAUB: Yes.

ROBERT J. KUEPPERS: Right.

PATRICIA FAIRFIELD: This is a perfect segue to the next broad issue that I wanted to raise which is, to put it succinctly, when we talk about principles versus rules, do we have any idea what we are talking about? Let me start with this question. When I was asked to moderate this program, I reached out to a number of people and someone sent me some legal research on the discussion of principles versus rules. In particular I was looking at an article by Lawrence Cunningham in the Vanderbilt Law Review. I didn't understand most of it because it was obviously legal research and a very different type of writing. But I was interested in a section in which he was trying to define principles versus rules and he said, "If you go through various schemas, there is clearly one categorization that differentiates between principles and rules based on when the boundaries are defined - either before action takes place or after." He said there is a different way to determine it according or to characterize them according to their relative specificity. And then finally he said there is a different way to characterize principles versus rules according to how much discretion they afford to the actors. Finally, he summed it all up by saying, the only thing any of these characterizations have in common is that principles are vague and rules are specific. I didn't find that real satisfactory and I am wondering if you have a better way to really differentiate principles versus rules. How do we know when we are looking at one versus another?

ROBERT J. KUEPPERS: One way to re-state what Mr. Cunningham had to say, talk about vague versus specific. I always think that a principle is broader and a rule almost by its nature is narrower and it's a sub-set of how one would apply the principle arguably if they are connected. But it troubles me to think that a principles set of standards are vague. I actually like a different term and it's the one that the SEC itself used in its study, talking about objectives-based. Because that means to me what are we trying to achieve. It has more of an aspirational notion. A principle sounds like a broad rule to me. If you frame it all up in terms of what the objectives are, what you are trying to account for in a standard, that just feels more like common sense to me. It feels better frankly. I don't know, Scott, how do you distinguish?

SCOTT A. TAUB: I think what Patty described is exactly why we coined the term objectives-based or objectives-oriented in the 2003 study because we realized that everybody had a different view of what principles-based meant. We actually set out to come up with a term that would be new so that perhaps we could define what we mean by that term and not compete with everybody's pre-conceived notions of what principles-

based might mean. I have not tried nor do I think I am capable of coming up with a definition of principles versus rules that would apply across the board to all situations in life. But with respect to accounting standards I believe that what we are all generally thinking in the direction of when we say principles-based or objectives-based, is that the standard would set out the principles or objectives that the accounting for the particular item in the scope of that transaction is supposed to be looking towards. Then, those applying the standard would be charged with finding a method of accounting that is consistent with those objectives and principles. Yes, there might be implementation guidance and there might be a little bit of it and there might be a lot of it. But the purpose of the implementation guidance is to illustrate the principles and objectives, not to say in each fact pattern here is how it breaks down and therefore you no longer need look back at the principles or objectives, you need only to look at the implementation guidance. I think where we have failed in U.S. GAAP is that we have gotten to a point where we look only to the implementation guidance with its rules and bright lines if they are there, and we don't worry about whether we complied with the underlying principles any more. So to me, when I think of rules-based, I think of a standard where we have gotten to the point where the goal is to comply with the rules rather than to reflect the principles and objectives in an intelligent way.

PATRICIA FAIRFIELD: Do you think that's a problem of the standards setting process or a problem of the implementation or the way the standards are being applied?

SCOTT A. TAUB: I think both those and the enforcement and the legal system. It all comes together.

ROBERT J. KUEPPERS: Scott's point is a huge point because I would argue that one's person's rules are not another person's implementation guidance. The purpose of implementation guidance is to show in an illustrative way how one would take the principle and apply it in practice, as opposed to saying: if you have got situation A, the answer's B, and if you have C, the answer's D. That devolves into rules very, very quickly. If you take it to the extreme and let's say the perfect set of standards, comprehensive set of standards, there are 50 of them and they are all very short and sweet and we could shrink it onto a wallet card and laminate it and carry it around and say, here's GAAP. Those principles in my mind are not operational unless and until you have a certain amount of implementation guidance to be illustrative again to demonstrate what's the impetus to the thinking. It's sort of like – what's the section in the back of the standards that we all go to?

SCOTT A. TAUB: The basis for concluding.

ROBERT J. KUEPPERS: It's like what was your thinking when you came up with this? And yet if it's taken too far and this is why we talk about IFRS and U.S. GAAP, we always get into this. There are folks principally I think east of the Atlantic that would suggest that Americans are going to ruin IFRS because they are going to implementation-guidance it to death and they will get into rules and we are going to take something good and ruin it. My point is that there is sort of this balance that has to be struck, but a healthy or appropriate or proper set of implementation guidance can actually flesh out the standard to make it operational.

PATRICIA FAIRFIELD: Can either or hopefully both of you give some examples of, I don't know if you think GAAP has any successful principles based standards in it or if IFRS does? Can you point to any or if not can you tell us some really horrible ones?

ROBERT J. KUEPPERS: That's so much easier.

SCOTT A. TAUB: Horrible ones are easier.

PATRICIA FAIRFIELD: I think we know the horrible ones so I would love to hear a good one.

SCOTT A. TAUB: I am going to start with an example of a horrible one that most people don't bring up. Everybody brings up FAS-133 and things like that as rules-based. I am going to bring up one that hits home to me because I was in the middle of this debate when I was at the SEC. When FAS-123R came out on expensing of stock options, there was a notion that the measurement date at which you measure the fair value of the option occurs when there is an understanding of the terms and conditions of the stock award between the grantor and the grantee. That's the principle; it sounds pretty good. Well, it turns out that sometimes the board of directors approves stock options grants to thousands of employees at one meeting and it may take a while for each individual employee to actually be notified of what his award was. So there was concern that perhaps that means that we actually don't hit a measurement date for each person's option grant until that person gets notification of his award because until then he doesn't understand the terms. The question is understandable and was asked to both the FASB staff and the SEC staff, who responded by saying something along the lines, well, a reasonable time period for communication is completely understandable and ought not to result in different measurement dates for every individual person's options. That was good enough for about two minutes and then everybody started asking quite literally, what is a reasonable period of time? Is it a day, is it a week, is it a month? And we wound up with a FASB staff position, a written explanation essentially of what we mean by having a common understanding of terms and conditions and what we mean by taking a reasonable amount of time to communicate things. And even that wasn't good enough. When that was finalized there were complaints that it was not specific enough because it does not say two weeks is reasonable. It instead provides some discussion of, you are using the delay to rethink whether you actually want to grant those options that would not be reasonable, whereas if it's just a matter of your normal corporate communications, that's fine. But it didn't have bright lines and people wanted bright lines. We took a principle in 123-R and decided we needed a lot of implementation guidance and then some people even wanted more implementation guidance in the form of rules. I thought that FSP FAS-123-R-1, if I get the number right, really exhibited why we have gotten to rules in so many instances.

PATRICIA FAIRFIELD: Well, let's back up a little. Or let me reiterate my question. Is there anywhere a standard that you think is successfully principle-oriented that has not degenerated?

SCOTT A. TAUB: I happen to think that FAS-123R when read alone is quite principles-based. It really is. You recognize the value of options at their fair value, there's implementation guidance to help you think about the issues that come in determining a grant date for the value of an option. But there aren't a lot of rules there and I think that it's pretty good. I think that FAS-141R is quite principles-based, the newest business

combinations standard. I do think that the standard setters are doing a reasonably good job. Certainly FAS-167 on VIE's consolidation of VIE's, is a lot more principles-based than its predecessor FIN46R.

ROBERT J. KUEPPERS: What about the same issue on the other side of the equation? What about share based payments under IFRS?

SCOTT A. TAUB: The share-based payment standards are broadly similar. So yes. I think that one is quite principles-based. Somewhat assured that by the way that the IFRS standard on revenue recognition is principles-based. It is certainly a lot shorter than our revenue recognition guidance.

PATRICIA FAIRFIELD: That was one of my questions. Is principles-based short?

SCOTT A. TAUB: Some people think so. I would characterize the IASB's guidance on revenue recognition as being so high level that it is in fact frequently unhelpful because it doesn't give enough guidance on what the principles are, how they were thought about and what the goals of revenue recognition accounting are. So I tend to think that, that standard is more like what the 2003 SEC study calls a principles only standard which, as Bob said, you can put the principles on a little laminated card but it's not actually to help you do good accounting.

ROBERT J. KUEPPERS: Right. And now on the other side. This is, you know, a historical event – a Fireside Chat, so I can reach back to the days when nobody will remember this - but I think one of the most ridiculous standards, even though I spent most of my waking hours applying it, was APB-16 where we had two completely different results of business combinations - purchase versus pooling of interest. The pooling of interest piece was the results of applying 10 or 12 tests and you could essentially if you had a pooling in substance, and you didn't want one, you just break one of the 10 or 12 rules and you had a purchase. I mean talk about a sort of a cook book. And leasing of course is the poster child often for bright lines with the 10%/90% and so forth. So anyway there are plenty of those kinds of examples. But I think Scott at the very beginning said that many standards are based on principles whether they are U.S. GAAP or IFRS and we all know, even though FAS-133 is kind of a whipping boy for a lot of things, that if we didn't have the carve outs or exceptions for hedging it could be actually a pretty darned simple standard. It's just an example.

SCOTT A. TAUB: One sentence...record derivatives at fair value, with changes through the income statement. We can do that.

ROBERT J. KUEPPERS: Exactly.

PATRICIA FAIRFIELD: And is there a standard that you want to point to that doesn't need implementation guidance, that you think stands on its own?

ROBERT J. KUEPPERS: I don't know or maybe am not smart enough to understand, Scott, what you are calling the principles-only standard. I would suggest in almost every major area of accounting a certain amount of implementation guidance would be prudent. I think this question of how much is enough and when do you devolve into something well beyond that somehow. I think that the acid test is that does it obfuscate the principle because you have got hundreds of pages of implementation

guidance and that obviously at some point we drift from our original idea. Let me say it this way. Take an historical point in time like 1933 when the Securities Act was passed, '34 when the Commission was formed, 75 years later we are sort of the students of a cumulative body of accounting principles. I mean we have got the old CAP stuff is embedded there, we have got the Accounting Principles Board, we have got the FASB obviously and it is a cumulative thing. Now where will we be a hundred years from now if we just stay on the same path? Is it just going to keep growing and growing because new trends and actions come forward? I think that's part of our dilemma is we are living in a time that has decades of accumulation and some of us would think that at what point do you retool. I don't want to start over but when does it get to be so much that it is just not helpful?

PATRICIA FAIRFIELD: I actually found the comment you made earlier about people being afraid that if Americans get too involved in IFRS we are going to ruin it because I am sure you have both heard the criticism that IFRS is really no more principles-based than GAAP is, it's just younger, and sooner or later it will turn out looking like GAAP. But Bob, you are suggesting that maybe the difference is not even that its younger, it's that the Americans haven't gotten there yet, we haven't been fiddling with it.

ROBERT J. KUEPPERS: Right. When the figures get pointed it's in that direction that the Americans could ruin this and in a couple of years' time - just give them a chance. And I am being cynical of course, but I do think that time tends to add and flush out things and the question is, when should you leave something alone and when should you fiddle with it. I mean I was at the first EITF meeting in 1984 and the issues we dealt with at that time were fairly narrow, they were fairly simple. The issue summaries were two pages and sometimes you reached a consensus and sometimes we didn't. But then if you look at the evolution of that and this is again people clamoring for guidance and the issue papers got to the point we couldn't read them in a day, at least I couldn't, 70 pages or something. It's the evolution of that over long periods of time that makes me think that there should be some kind of a sunset on all these things and we should rethink it from time to time, just because process sometimes feels like it takes over the substance of what you are trying to achieve.

SCOTT A. TAUB: Patty as you know I am on IFRIC right now, the IASB's version of the EITF and I can tell you that the questions that people send up to IFRIC where the suggestion is we need guidance on this, are exactly the same kind of questions as gets sent to the FASB and the EITF about the U.S. GAAP. They are as detailed, as specific and as often as in U.S. GAAP, clearly the people asking the question are looking for a rule so that they know exactly what to do in their fact pattern. To date, the IASB has in Bob's words generally resisted fiddling with those and both the IASB and IFRIC have largely rejected those issues and decided not to write guidance about them. Certainly in the U.S. at least in the last 20 years or so, I think a lot of the questions that the IFRIC and the IASB decided not to address, the FASB and the EITF have addressed similar questions and have come up with guidance. So, there certainly is I think at the standard setter level at the IASB now a different philosophy than was in place at the FASB over the last 20 years or so. We will see how long that lasts. As Bob points out we have been laboring under U.S. GAAP for 75 years. IFRS for all of its good attributes has only been widely used for about four years. So, it's not surprising that there is less guidance under IFRS than there is under U.S. GAAP. I have generally been optimistic about the way IFRIC and the IASB respond to these requests and they have generally rejected the issues, but not always. There are some issues that IFRIC has addressed, one

particularly that's on the agenda now that I was surprised that people thought under IFRS people thought that we needed the guidance. So there is certainly the possibility that IFRS will eventually head that way if people continue to ask for the guidance and eventually the standard setter determines, well, there's enough people asking so we better give it to them.

PATRICIA FAIRFIELD: One of our more critical accounting professors, I don't know if you know, Shawn Sumner?

SCOTT A. TAUB: I know Shawn very well.

PATRICIA FAIRFIELD: He criticizes the standard setters from many directions but one of the things that he seems to say is that if we have standard setters they will set standards. When you are talking about the IASB versus the FASB, I am wondering maybe they don't just have as much time to set standards and therefore they don't set as many.

SCOTT A TAUB: Well, there is certainly smaller staff in London than there is in Norwalk so perhaps at least directionally that's true. I haven't seen it as you know there are more board members in London than in Norwalk.

PATRICIA FAIRFIELD: Right.

SCOTT A TAUB: So it's not clear to me that the fact that there is a standard setter means they will write enough standards to fill up all their time. I think that really the size of the FASB has not driven the amount of standards; rather it's the other way around as more. As more standards and guidance were demanded, the FASB got bigger or smaller to meet that demand, at least that's my impression.

ROBERT J. KUEPPERS: But don't you think at some point whether it's in London or Norwalk that group sitting around the table will look at each other and some day say, "Our work here is finished."

SCOTT A. TAUB: I hope that's true.

PATRICIA FAIRFIELD: That is a nice thought.

ROBERT J. KUEPPERS: We have completed the body of standards that are needed for mankind...

SCOTT A. TAUB: I hope that some day the SEC doesn't need a rule writing group because we've written all the rules that we need. It seems like just a dream but at least logically we all ought to hope that we get to that point.

ROBERT J. KUEPPERS: Exactly.

PATRICIA FAIRFIELD: I am going to back to this question in a little different context about implementation guidance. I understand, Bob that you said there is a need for it. But I am wondering if we have principles-based accounting and we are successful at push back on the amount of implementation guidance that's being issued by standard setters that we might end up in a situation where the Big Four and maybe others are

internally creating their own implementation guidance and for the sake of not duplicating their thought process, they are codifying it internally and we end up with Deloitte-GAAP and KPMG-GAAP, different ones which might be a good thing. I mean we, there are Shawn Sumner among others, says competition among regulation is a good thing, maybe it is and this would certainly be a way until we get there.

ROBERT J. KUEPPERS: It's actually a great question because what I just said a little bit earlier is there is sort of this optimal amount, not too big, not too small, the Goldilocks version of implementation guidance is adequate and it should work. But as we all know what tends to happen, and I really believe this is more for efficiency and so forth, we tend to write accounting manuals and interpretations of our own. Particularly, I will give you a great example, major transaction on major client and it's been through the SEC and it came out a certain way and we learned a lot from that experience. We want everybody in our practice to realize if you run into this, this one's already been specifically pre-cleared or post-cleared by the SEC. So we tend to get that out to our people so they can see it. I will be honest with you, I worry that the perpetuation by the firms of too many details or some version of rules as an underpinning for the guidance that's already published is a little concerning. Because one of my big problems, one of my big questions is, whoever's standards they are, principle-based, with an optimum amount of implementation guidance is going to require more judgment, it is going to require I think a more civil interchange with clients about what's the best accounting and what's the right answer. It harkens back to the days I started in the profession but we have got thousands of people in the audit practice and most of them have literally grown up in a more of a rules type environment. So how do we retool and train people to succeed in this different world if it comes to pass? So, I don't want to undermine it with 850 pages of Deloitte-GAAP or our colleagues at the other firms doing the same thing, but I can't tell you that some of that won't occur.

PATRICIA FAIRFIELD: But let me ask you a question that was sent in to us by Edith Orenstein and that concerns, and I am afraid I am not going to do the question justice here, but it concerns the role of professional judgment in accounting and auditing. It was prompted by last week's conversation and she noted that some people are of the view that a professional judgment framework such as the one that was recommended by the CIFI Committee would be a type of panacea providing protection against second guessing by regulators or the plaintiff's bar and potentially increasing accounting and audit quality. But that others believed that unintended consequences arriving from the imposition of a specified professional judgment framework could prove just the opposite. That is, it would prove this professional judgment framework would be very nerve wracking in establishing a requirement, a required set of bells and whistles which would lead to increased litigation risk rather less litigation risk. So, I am wondering if you can comment on what you think would be the result?

ROBERT J. KUEPPERS: My short answer is that world is a judgment framework driven world is neither a panacea nor a nightmare. I still believe that has tremendous potential for a durable approach to making decisions and judgments, professional judgments and I think one of the big counters is people that say and let's relate it to standards - rules are good, rules give you something very specific to point to or justify, hide behind, depending on your point of view. Less specificity is going to require some kind of a cogent approach to making professional judgments that will stand up to what they want to call second guessing or review by others. But it does create the possibility that litigation and those kinds of risks feel heightened. But I have got to tell you if I had to

choose, a big part of me after some 33 years of doing this, is to go to the judgment approach, defend my judgment even though I recognize in a litigation context it might be what we call dueling experts. I would certainly rather defend my professional judgment than say well, I relied on footnote 3 therefore I am okay. I mean I feel like the other way hasn't worked either and I am almost ready to go back to a more, let me call a little argumentative but a different method of defending one's work. That maybe a bit costly, I should be careful but I actually believe it's a better world to live in.

SCOTT A. TAUB: I agree with everything that you just said, Bob, and not because I am in a position to be one of those dueling experts but because that's exactly consistent with my thinking. I think those who look at the potential of a professional judgment framework as a panacea and those that look at it as a trap are misunderstanding the purpose of the judgment framework. The purpose is to get to better accounting answers, its not to protect, it's not to mandate a way to do things. It's to help people who are applying accounting standards that are difficult to apply that require judgments to make those judgments in an intelligent way. And if you have made your judgments in an intelligent way it ought to be the truth that's the SEC's Enforcement Division would not think you are a bad actor that deserves to be expelled from the profession and it ought to be the case that plaintiffs do not think you owe them anything. Now I am not a good enough student of the legal system to give you a prediction as to whether that would happen or not but it certainly ought to if you have applied your judgment in an intelligent way.

PATRICIA FAIRFIELD: Let's talk a little bit about the potential costs and I don't necessarily mean litigation costs but other costs of moving to a principles based accounting regime specifically cost of preparing and auditing and analyzing the financial statements. And in particular I am raising this issue because last week when I was listening, Greg Jonas mentioned that in this CIFiR report there was a list of I think he said 12 steps - 12 maybe a magic number in accounting - 12 steps that needed to be applied in coming up with a professional judgment and one of those was that you were supposed to consider the alternative accounting treatments and explain why you rejected the alternative accounting treatments in favor of the one that was accepted. Now I can just imagine scenarios where the cost of doing this would become just enormous. Now I am wondering if you think this is, does it sound like this will be a problem going down this road or do you see ways around this?

ROBERT J. KUEPPERS: Let me start and I would really be interested in Scott's views. I mean a 12 step program sounds like accounting rehab but I really do believe that the 12 is fairly artificial. I viewed it maybe as four or five. The process is the same to identify the problem, gather the facts, analyze the alternatives, consult, decide, document, disclose. I mean it's not wholly different from what people do today, it's perhaps a bit more disciplined and remember this would not be applied to every little tiny thing that one does but this would be applied to significant, material things - things that maybe recur. So this one isn't material but we are going to do it a million more times so we got to get it right in terms of our accounting principles. There may be some cost. I think in this area when people raise cost you are usually thinking about implementation of IFRS and sort of transitioning to a new system more than they are to the judgment framework. What is the right amount... let's go back to what Scott said, if the result is better accounting and more durable decisions and things like that, I don't know what the cost benefit equation is because the benefits side is very hard to measure. I think you used the word tremendous or enormous or very large cost. I am not seeing it that way, I am

seeing it as if you follow that you should be in great shape on Sarbanes-Oxley, on internal controls, on the kinds of things we are already looking at ever since 2002.

SCOTT A. TAUB: There are certainly going to be shifts in where people spend their time if we get rid of some rules and put in more objectives-based or principles-based standards and the thinking of those preparing financial statements will have to change. They used to spend time figuring out if they have complied with Paragraph 232E, now they will need to think about the principle that drove somebody to write Paragraph 232E and think about whether they are indeed being consistent with that principle. I don't perceive that as necessarily adding a lot of time or cost. I think it is clearly a shift in the way people will spend their time and I think it's probably a shift towards spending your time on more interesting things. I would certainly rather think about whether my accounting is achieving a desired set of or is consistent with a desired set of principles and objectives than add up the least payments and figure out whether they are 89% or 90%. That's just math. My son is six; he's really good at math. I could have him do that.

PATRICIA FAIRFIELD: Can we talk a little bit just about how you think this will benefit investors? I think I know where you stand here but first of all under principles versus rules which one do you think will have the greatest disclosure for investors? And do you think that from an investor's perspective under principles-based accounting they would have a sufficient understanding both of the principles and then sufficient disclosure documentation for them to understand what the underlying transactions were?

ROBERT J. KUEPPERS: I think you used the word greatest disclosure and I wasn't sure whether that meant the greatest volume or the best.

PATRICIA FAIRFIELD: Best.

ROBERT J. KUEPPERS: ... if we think about it in terms of the best disclosure on paper, that's dangerous too. In theory I think the general disclosure requirement of principles, objectives based standards, IFRS in particular, is to not only capture the economic substance but the transparency that goes behind the decision you made is a very important part of that. At the same time I am not so facile with the body of standards to know with great specificity but I suspect the specific requirements for disclosure maybe greater in US GAAP, in other words the enumeration of things that one must disclose and then of course you had the SEC rules on top of that. So, I don't know the truth but my own instincts are that the spirit of the disclosure requirements in principles based standard would be better, higher quality. But boy, when you start taking that and layering it onto a U.S. system where, more of, I hate to say it but more of a check list mentality has been used, I am not sure how that will play out. So if people are faithful to the idea, sure I think you might actually end up with improved disclosure but my confidence that's going to occur is somewhat muted.

SCOTT A. TAUB: I think the key is being faithful to the idea. MD&A is a wonderful disclosure standard. At its core it says, you should disclose the things people need to know to understand what happened. That's what it says. If you read MD&A, it's hard to believe that the people were simply following that principle.

PATRICIA FAIRFIELD: I disagree with that. I read financial statements a lot. And not always but I often find information in MD&A that I think is very, very useful for trying to figure out what's going to happen in the next period.

SCOTT A. TAUB: Oh absolutely. I am not saying MD&A doesn't contain useful information. I am saying that it also contains information that is not driven from that principle but is driven from, I always disclose that sales increased by 3.1% and yada yada yada. To find the nuggets of information in an MD&A, I think you wind up wading through a lot of stuff that sounds compliance oriented. I think in a principles-based system quality of disclosures not necessarily quantity but quality of disclosures is necessary in order to make the principles-based system work because there is going to be more deviation. There simply will be people who will apply things differently and I think investors are intelligent enough to deal with diversity if they know about it. They are only going to know about it if there are good policy disclosures and I think in U.S. GAAP today we often don't have good policy disclosures. That would become even more of a problem if we were in a more principles based system.

PATRICIA FAIRFIELD: I am watching our clock here and we do have to wind up. I am wondering Bob or Scott, if either one of you want to take 30 seconds and say anything in closing, otherwise I, go ahead.

ROBERT J. KUEPPERS: I don't have any wisdom to impart but I think Scott's comments today were particularly helpful and I really appreciate your participation.

SCOTT A. TAUB: I am glad to be here and I am looking forward to looking back on this in a few years and seeing if we still sound as intelligent as I think we sounded for the last hour.

PATRICIA FAIRFIELD: Thank you both for an engaging discussion. This program along with the October 22nd program on professional judgment will be important additions to the virtual museum and archive's collection on accounting. I would like to encourage our audience to explore the collection at www.sechistorical.org and to access the significant material that is there on accounting. On behalf of the SEC Historical Society I would like to thank Deloitte LLP for its generous support and assistance in making both today's program and the October 22nd's program possible. You can listen again to an audio of this program on www.sechistorical.org at any time. An edited transcript will be available on the website soon. Thank you again for being with us today.