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PROPOSAL

PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING

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Financial Accounting Standards Board
of the Financial Accounting Foundation

PROPOSAL FOR A PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING

This proposal discusses a principles-based approach to standard setting to improve the quality and transparency of financial accounting and reporting in the United States. This proposal requests comments about the approach by January 3, 2003. The Board plans to hold a public roundtable meeting with respondents to the proposal on December 16, 2002.

U.S. FINANCIAL ACCOUNTING AND REPORTING

Objectives

The need for information on which to base investment, credit, and similar decisions underlies the objectives of U.S. financial accounting and reporting. The mission of the Financial Accounting Standards Board (FASB) is to develop high-quality accounting standards that serve the public interest by providing information that is useful to present and potential investors and creditors and other users in making investment, credit, and other similar decisions.

The primary qualities of decision-useful information are relevance and reliability. To be relevant, information must be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations. Timeliness, that is, having information available to decision makers before it loses its capacity to make a difference, is an ancillary aspect of relevance. To be reliable, information must be representationally faithful, verifiable, and neutral, reporting economic activity as faithfully as possible. That is, it must not be intentionally biased to attain a predetermined result; for example, to foster a particular government policy, to favor one economic interest over another, or to otherwise influence behavior in any particular direction. To do so would undermine the proper functioning of the capital markets, limiting the ability of investors and creditors to make informed capital allocation decisions. Comparability, including consistency, is a secondary quality that interacts with relevance and reliability to contribute to the usefulness of information. Comparability is achieved if similar transactions and events are accounted for similarly and different transactions and events are accounted for differently.

In a February 2000 letter, the Association for Investment Management and Research, an organization of over 40,000 investment professionals, emphasized:

> The "lifeblood" of United States capital markets is financial information that is: (1) comparable from firm to firm; (2) relevant to investment and financing decisions; (3) a reliable and faithful depiction of economic reality; and (4) neutral, favoring neither supplier nor user of capital; neither buyer nor seller of securities. [page 2]

The FASB's mission statement indicates that high-quality accounting standards that improve the transparency of information "are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information." Understandable financial information permits reasonably informed users to perceive the usefulness of the information. Financial information cannot be useful to decision makers who cannot understand it, even though it may otherwise be relevant, reliable, and comparable.

Recent Concerns

Recently, many have expressed concerns about the quality and transparency of U.S. financial accounting and reporting. A principal concern is that accounting standards, while based on the conceptual framework, have become increasingly detailed and complex. Many assert that, as a result, it is difficult for accounting professionals to stay current and that accounting standards are difficult and costly to apply. Many also assert that because much of the detail and complexity in accounting standards results from rule-driven implementation guidance, the standards allow financial and accounting engineering to structure transactions "around" the rules, thereby circumventing the intent and spirit of the standards.[1] In testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Harvey L. Pitt, chairman of the U.S. Securities and Exchange Commission (SEC), said:

> Much of FASB's recent guidance has become rule-driven and complex. The areas of derivatives and securitizations are examples. This emphasis on detailed rules instead of broad principles has contributed to delays in issuing timely guidance. Additionally, because the standards are developed based on rules, and not broad principles, they are insufficiently flexible to accommodate future developments in the marketplace. This has resulted in accounting for unanticipated transactions that is less transparent and less consistent with the basic underlying principles that should apply. The development of rule-based accounting standards has resulted in the employment of financial engineering techniques designed solely to achieve accounting objectives rather than to achieve economic objectives. [March 21, 2002; footnote reference omitted.]

Many factors shape the development of accounting standards. However, in the Board's view, much of the detail and complexity in accounting standards has been demand-driven, resulting from (1) exceptions to the principles in the standards and (2) the amount of interpretive and implementation guidance

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[1] For example, some refer to situations in which complex structures or a series of transactions (in some cases, with several parties) are created to achieve desired accounting results—for example, to remove assets from the balance sheet while retaining the overall economics of the assets, to recharacterize assets, or to improve cash flows from operations.

provided by the FASB and others for applying the standards. Those factors are discussed below.

Exceptions to the Principles

Exceptions in accounting standards create situations in which the principles in the standards do not apply. Such situations often result from compromises made to balance the need for decision-useful information with the practical concerns of the Board and its constituents. For example, some exceptions are provided to allow the accounting for transactions and events that would otherwise be accounted for under the standards to continue under other existing accounting pronouncements (scope exceptions). Other exceptions are provided to achieve a desired accounting result, for example, to limit the volatility of reported earnings that would result by applying the principles in the standards (application exceptions). Yet other exceptions are provided to mitigate the effects of transitioning to new accounting standards (transition exceptions).

Exceptions, by themselves, increase the level of detail and complexity in accounting standards because rules and related interpretive and implementation guidance often are needed to describe and limit the transactions and events that are exempt from the provisions of the standards. Indeed, accounting standards most often referred to as detailed and complex, such as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* provide numerous exceptions, rules, and related interpretive and implementation guidance, establishing what many refer to as rules with "bright-lines" and "on-off" switches that focus on the form, rather than the substance, of the transactions. One reason Statement 133 is complex is that the transactions covered by that Statement are complex. However, the exceptions in Statement 133 (which include both exceptions to the principles and exceptions to those exceptions) add significantly to that complexity. (Refer to Attachment A.)

Interpretive and Implementation Guidance

The main reason for interpretive and implementation guidance in accounting standards is to ensure some level of comparability, that is, that certain similar transactions and events covered by the standards are accounted for similarly by all entities. That guidance also is provided to deal with situations in which exceptions apply, as discussed previously, and as an educational tool. Also, some believe that detailed interpretive and implementation guidance that provides a "single" answer to every question is important in an increasingly litigious environment. Not only does detailed guidance provide the SEC with an effective enforcement mechanism, others (including preparers and auditors) have indicated a need for detailed guidance because it limits the ability of the SEC and others to second-guess professional judgments.

Over the years, the amount of interpretive and implementation guidance provided has increased significantly, adding to the complexity in applying accounting standards. In addition to the guidance in accounting standards, guidance is provided after accounting standards are issued—by the FASB (and its staff), the FASB Emerging Issues Task Force (EITF), the AICPA Accounting Standards

Executive Committee (AcSEC), special task force groups such as the FASB Derivatives Implementation Group (DIG), and, for SEC registrants, the SEC. That guidance tends to focus on specific transactions and industries, in some cases, extending, by analogy, treatments and exceptions in the standards to other transactions and events. Further, it has different levels of authority in the body of accounting literature that comprises U.S. generally accepted accounting principles (GAAP).[2]

PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING

In response to those and other related concerns, the Board decided to consider the feasibility of adopting a principles-based approach to U.S. standard setting, similar to the approach used in developing International Accounting Standards (IAS) and accounting standards used in other developed countries, such as the United Kingdom. In testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Sir David Tweedie, chairman of the International Accounting Standards Board (IASB), explained:

> Many International Financial Reporting Standards (IFRS) are similar to U.S. GAAP. Both international standards and U.S. GAAP strive to be principles-based, in that they both look to a body of accounting concepts. U.S. GAAP tends, on the whole, to be more specific in its requirements and includes much more detailed implementation guidance.
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> We favour an approach that requires the company and its auditor to take a step back and consider whether the accounting suggested is consistent with the underlying principle. This is not a soft option. Our approach requires both companies and their auditors to exercise professional judgment in the public interest. Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures. It will not work without those commitments. There will be more individual transactions and structures that are not explicitly addressed. We hope that a clear statement of the underlying principles will allow companies and auditors to deal with those situations without resorting to detailed rules. [February 14, 2002]

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[2] Included in the GAAP hierarchy set forth in Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report,* are FASB Statements, which are Level A GAAP (for SEC registrants, SEC rules and interpretive releases have equal authority); AcSEC documents cleared by the FASB, which are Level B GAAP; EITF consensuses and AcSEC documents not cleared by the FASB, which are Level C GAAP; and FASB staff implementation guidance, including the guidance provided through the DIG process, which is Level D GAAP.

Many, including the chairman of the SEC and members of Congress, have referred to the need for a similar approach to U.S. standard setting.[3]

This proposal describes the main changes that would be made to accounting standards developed under a principles-based approach. The attachments to this proposal illustrate in more detail the implications of that approach by reference to existing accounting standards. Attachment A discusses the effect of a principles-based approach on certain aspects of Statement 133. Attachment B shows how the standards section of FASB Statement No. 34, *Capitalization of Interest Cost,* might look if developed under that approach (Revised Statement 34).[4] Attachment C reflects the guidance in Statement 34 that is not retained in the Revised Statement 34. The Board emphasizes that, if adopted, a principles-based approach to standard setting would require changes in the processes and behaviors of all participants in the U.S. financial accounting and reporting process, not just the FASB and other standard-setting bodies. *Thus, in order for that approach to work, all participants must be equally committed to making those changes*.

Accounting Standards

In accounting standards developed under a principles-based approach, the principles reflecting the fundamental recognition, measurement, and reporting requirements of the standards would continue to be developed using the conceptual framework. The main differences between accounting standards developed under a principles-based approach and existing accounting standards are (1) the principles would apply more broadly than under existing standards, thereby providing few, if any, exceptions to the principles and (2) there would be less interpretive and implementation guidance (from all sources, not just the FASB) for applying the standards. That, in turn, would increase the need to apply professional judgment consistent with the intent and spirit of the standards.

Principles Developed Using the Conceptual Framework

In developing existing accounting standards, the FASB has used its conceptual framework. The conceptual framework is a series of Financial Accounting Concepts Statements that provide the foundation for U.S. financial accounting and reporting. Each Concepts Statement includes in its preface a similar description:

> Statements in the series are intended to set forth objectives and fundamentals that will be the basis for development of financial

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[3] Section 108(d) of the Sarbanes-Oxley Act of 2002 requires the SEC to conduct a study on "the adoption by the United States financial reporting system of a principles-based accounting system" and to submit a report on the results of the study to Congress within one year of enactment of the Act (by July 2003).

[4] Attachment B retains the fundamental principles of Statement 34. The Board did not reconsider those principles or otherwise conclude on whether they would change if Statement 34 were reconsidered currently, for example, as part of an international convergence project.

> accounting and reporting standards. The objectives identify the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting—concepts that guide the selection of transactions, events, and circumstances to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties. Concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting, and applying accounting and reporting standards.

Although the FASB has used its conceptual framework in developing accounting standards, that framework has not provided all the requisite tools for resolving accounting and reporting problems. In part, that is because certain aspects of the conceptual framework are incomplete, internally inconsistent, and ambiguous. For example:

- FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* does not provide conceptual guidance necessary for making tradeoffs among the qualities of relevance and reliability and comparability and consistency.
- Because of compromises necessary to issue it, the guidance in FASB Concepts Statement No. 5*, Recognition and Measurement in Financial Statements of Business Enterprises,* includes a description of practices existing at that time, providing little, if any, conceptual basis for analyzing and resolving the controversial issues of recognition and measurement. Among other things, Concepts Statement 5 does not provide the requisite tools for assessing whether items should be measured at fair value and, if so, when (as it relates to initial and subsequent measurements), at what level of aggregation, and how.
- The revenue recognition guidance in Concepts Statement 5 is, in some respects, inconsistent with the guidance in other areas of the conceptual framework; in particular, the definitions of assets and liabilities (and other elements) in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Further, the definitions in Concepts Statement 6, themselves, lack clarity.
- The conceptual framework does not include a framework for developing disclosure requirements.

Accounting standards with principles that apply more broadly than under existing accounting standards would require a conceptual framework that is complete, internally consistent, and clear. Thus, the Board would need to commit resources to a project to improve the conceptual framework. The Board has not yet developed a prospectus for a conceptual framework improvements project. However, as part of such a project, the Board expects to address the items discussed above.

The Board also expects to consider the need for an overall reporting framework similar to that in IAS 1 (Revised), *Presentation of Financial Statements*. The main objective of that reporting framework would be to provide guidance on issues such as materiality assessments, going-concern assessments, professional judgments, accounting policies, consistency, and presentation of comparative information. It also could include a true and fair view override to deal with the extremely rare circumstances in which management concludes that compliance with a requirement in an accounting standard would be so misleading that it would conflict with the objectives of financial accounting and reporting.[5] Some believe that such an override is needed to more clearly convey the economic substance of transactions and events in such circumstances, while others believe that such an override would undermine the principles in the standards, regardless of limitations on its use.

Few, if Any, Exceptions to the Principles

Accounting standards with few, if any, exceptions to the principles would lead to more situations in which similar transactions and events are accounted for similarly, thereby enhancing comparability and reducing the level of detail and complexity that arises from exceptions. The Board acknowledges that, as a practical matter, it might not be possible to eliminate all scope and transition exceptions. However, to more clearly convey the economic substance of transactions and events covered by the standards, the Board believes that an objective of a principles-based approach should be to eliminate all application exceptions. Because such exceptions are provided to achieve desired accounting results (for example, to limit the volatility of reported earnings that would result by applying the principles in the standards), they may obscure the underlying economics of the related transactions and events covered by the standards.

In "Commentary on Financial Reporting—Economic Consequences: The Volatility Bugaboo," former FASB Board member Robert T. Sprouse makes the case for reflecting actual volatility in reported earnings:

> I submit. . . that minimizing the volatile results of actual economic events should be primarily a matter for management policy and strategy, not a matter for accounting standards. To the extent volatile economic events actually occur, the results should

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[5] IAS 1 includes a true and fair view override. In the IAS Exposure Draft, *Proposed Improvements to International Accounting Standards,* the IASB proposes to similarly limit the use of that override in the extremely rare circumstances in which management concludes that compliance with a requirement in an IAS would be so misleading that it would conflict with the objectives of financial accounting and reporting. The U.S. equivalent is found in Rule 203 of the AICPA Code of Professional Conduct, which prohibits a member of the Institute from expressing an opinion that financial statements conform with GAAP if those statements contain a material departure from an accounting principle promulgated by the FASB, unless the member can demonstrate that because of unusual circumstances the financial statements otherwise would have been misleading.

> be reflected in the financial statements. If it is true that volatility affects market prices of securities and the related costs of capital, it is especially important that, where it actually exists, volatility be revealed rather than concealed by accounting practices. Otherwise, financial statements do not faithfully represent the results of risks to which the enterprise is actually exposed.
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> To me, the least effective argument one can make in opposing a proposed standard is that its implementation might cause managers or investors to make different decisions . . . .The very reason for the existence of reliable financial information for lenders and investors…is to help them in their comparisons of alternative investments. If stability or volatility of financial results is an important consideration to some lenders and investors, all the more reason that the degree of stability or volatility should be faithfully reflected in the financial statements. [*Accounting Horizons,* March 1987, page 88]

In that regard, the Board would need to resist pressures to provide exceptions. Other participants in the U.S. financial accounting and reporting process, including preparers, investors, creditors, and other users of financial information, must accept the consequences of applying accounting standards with fewer exceptions, including increased volatility of reported earnings.

Less Interpretive and Implementation Guidance

An approach emphasizing principles that apply more broadly than under existing accounting standards would not eliminate the need to provide interpretive and implementation guidance for applying the standards. However, the Board believes that it would significantly reduce the need for that guidance, especially as exceptions and other complexities are phased out. Further, the Board believes that the guidance provided should focus only on significant matters addressed in the standards, increasing the need to apply professional judgment consistent with the intent and spirit of the standards to other situations not addressed, including situations specific to entities and industries.

The importance of professional judgment in applying accounting standards is referred to in the dissent to FASB Statement No. 66, *Accounting for Sales of Real Estate,* which states:

> Mr. Walters dissents to the issuance of this Statement primarily because he objects to incorporating these complex, rigid, and detailed rules into accounting standards. Entirely aside from the conceptual merit of these rules, which is at least debatable, he believes the Board should focus at about the level expressed in paragraphs 3 and 4 of this Statement. Beyond that, he believes the accounting profession can serve its members by offering more specific *guidance* for applying the 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.

Less interpretive and implementation guidance for applying accounting standards has significant implications for all participants in the U.S. accounting and reporting process, as discussed below.

For its part, the Board would need to establish guidelines sufficient to identify situations in which interpretive and implementation guidance is appropriate, and to resist pressures to provide guidance in other situations. In that regard, changes to the roles, composition, and processes of other standard-setting bodies, such as the EITF and AcSEC, would be necessary to ensure that (1) the same (or similar) guidelines are used after the standards are issued and (2) the guidance provided is consistent with the intent and spirit of the standards.

Preparers and auditors would need to apply professional judgment in more circumstances, while the SEC, investors, creditors, and other users of financial information must accept the consequences of applying professional judgment, including some divergence in practice. Concerns about SEC enforcement actions and related litigation matters are significant, potentially affecting the extent to which preparers and auditors would be willing to apply professional judgment in more circumstances. The ability of the SEC to address those concerns will be critical in order for a principles-based approach to work.

Benefits and Costs

The Board acknowledges that, if adopted, a principles-based approach could impose some costs. For example, the approach discussed in this proposal could lead to situations in which professional judgments, made in good faith, result in different interpretations for similar transactions and events, raising concerns about comparability. In response, it is possible that absent additional FASB guidance, others, having the requisite resources to develop interpretive and implementation guidance would, in effect, become defacto standard-setting bodies and develop related guidance without the due process provided by the FASB. Further, the approach discussed in this proposal also could lead to abuse, whereby the principles in accounting standards are not applied in good faith consistent with the intent and spirit of the standards. Those and other similar types of situations could make it difficult for the SEC and other participants in the U.S. financial accounting and reporting process to adjust to a principles-based approach.

However, the Board notes that accounting standards with principles that apply more broadly than under existing standards should be easier to understand and implement. Further, increased use of professional judgment in applying the standards should more clearly convey the economic substance of the transactions and events covered by the standards, for example, by reducing the extent of financial accounting and engineering to structure transactions around more specific rules. Also, few, if any, exceptions to the principles in the standards should increase comparability. In addition, interpretive and implementation guidance would continue to be provided within guidelines established by the Board (where matters affecting the transactions and events covered by the standards are significant).

On balance, the Board believes that if other participants in the U.S. financial accounting and reporting process make the changes required under a principles-based approach, the benefits of adopting that approach would outweigh its costs. The result would be high-quality accounting standards that improve the transparency of financial information essential to the efficient functioning of the economy. Also, because the standards will be less detailed and specific, they will be more responsive to emerging issues in the changing financial and economic environment in which many companies operate. Further, because a principles-based approach is similar to the approach used in developing IAS and accounting standards used in other developed countries, adopting such an approach could facilitate convergence as the FASB works with the IASB and other national standard setters in developing common high-quality accounting standards.

REQUEST FOR COMMENTS

The Board believes that an approach focusing more clearly on the principles in accounting standards is necessary to improve the quality and transparency of U.S. financial accounting and reporting. However, because adopting that approach would require changes in the processes and behaviors of all participants in the U.S. financial accounting and reporting process, the Board needs more information before it determines the extent to which it should undertake initiatives to adopt that approach, including improvements to its conceptual framework. The Board seeks comments on its proposal to adopt a principles-based approach to U.S. standard setting, in particular, on the following issues.[6] To the extent that respondents choose to comment on the issues, it would be helpful if comments respond to the issue as stated and include the reasons for the positions taken. However, respondents are encouraged to comment on additional issues they believe the Board should consider.

1. Do you support the Board's proposal for a principles-based approach to U.S. standard setting? Will that approach improve the quality and transparency of U.S. financial accounting and reporting?
2. Should the Board develop an overall reporting framework as in IAS 1 and, if so, should that framework include a true and fair view override?

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[6] The SEC staff plans to consider comments from respondents to this proposal in connection with its study on the adoption of a principles-based approach mandated by the Sarbanes-Oxley Act of 2002.

3. Under what circumstances should interpretive and implementation guidance be provided under a principles-based approach to U.S. standard setting? Should the Board be the primary standard setter responsible for providing that guidance?

4. Will preparers, auditors, the SEC, investors, creditors, and other users of financial information be able to adjust to a principles-based approach to U.S. standard setting? If not, what needs to be done and by whom?

5. What are the benefits and costs (including transition costs) of adopting a principles-based approach to U.S. standard setting? How might those benefits and costs be quantified?

6. What other factors should the Board consider in assessing the extent to which it should adopt a principles-based approach to U.S. standard setting?

The Board plans to hold a public roundtable discussion with respondents to the proposal on December 16, 2002. If you are interested in participating, please let us know by November 18, 2002, and submit comments about the proposal by December 2, 2002. Otherwise, please submit comments by January 3, 2003. Correspondence should be sent via email (File Reference 1125-001) to director@fasb.org.

STATEMENT 133

This attachment discusses the effect of a principles-based approach on certain aspects of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

The accounting under Statement 133 was developed based on the three fundamental principles in paragraph 3(a)–(c) and the principle in paragraph 3(d), that conditionally accepts hedge accounting. Those principles follow.

a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.

b. Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value, and adjustments to the carrying amount of hedged items should reflect changes in their fair value (that is, gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.

c. Only items that are assets or liabilities should be reported as such in financial statements.

d. Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged.

However, Statement 133 includes detailed "rules" (in the form of characteristics, conditions, and criteria) specifying whether and, if so, how to apply those principles, together with exceptions to those principles and extensive related interpretive and implementation guidance. Not only is that detailed guidance provided in Statement 133, additional guidance was provided after the Statement was issued through the FASB Derivatives Implementation Group (DIG), which addressed nearly 180 implementation issues. For example:

- Paragraph 6 defines a derivative instrument. That definition is discussed further in paragraphs 7–9. After Statement 133 was issued, additional guidance was provided through the DIG process. The DIG addressed 22 issues relating to the definition of a derivative instrument (DIG Issues A1–A22).

- Paragraphs 10 and 11 provide nine exceptions to the definition of a derivative instrument in paragraph 6, as supplemented by paragraphs 7–9. Those exceptions exclude from the scope of Statement 133 certain contracts that would otherwise be considered derivative instruments. After Statement 133 was issued, additional guidance was provided through the DIG process. The DIG addressed 19 issues relating to scope exceptions (DIG Issues C1–C19), further clarifying which derivative instruments are exempt from the provisions of the Statement.

- Paragraph 12 discusses derivatives embedded in other contracts. Rather than requiring that all such derivatives be accounted for separately, paragraph 12(a) provides an exception to that requirement for derivatives for which the underlying is clearly and closely related to the host contract, as further explained in paragraph 13. Paragraph 15 provides yet another exception to that requirement for embedded foreign currency derivatives in certain other circumstances. Although paragraph 13 establishes boundaries so that only contracts that meet certain criteria as to leverage can qualify for the clearly-and-closely-related exception in paragraph 12(a), paragraph 14 provides an exception to those boundaries so that some contracts that would not otherwise qualify for that exception will qualify under paragraph 14.
- Not only is extensive guidance related to embedded derivatives included in Statement 133 (paragraphs 60 and 61 of Appendix A and paragraphs 171–200 of Appendix B), additional guidance was provided after Statement 133 was issued through the DIG process. The DIG addressed 36 issues relating to embedded derivatives, many of which resulted from the clearly-and-closely-related exception in paragraph 12(a) (DIG Issues B1–B36).
- Statement 133 also provides an exception to the requirement that certain embedded derivatives be accounted for separately as a derivative instrument, such that the contract as a whole is measured at fair value if the embedded derivative cannot be reliably identified and measured.
- For items designated as hedged items, Statement 133 provides special accounting that is different from the guidance in other accounting standards that would otherwise apply. Special requirements must be met in order for those items to qualify for the special accounting (paragraphs 20, 21, 25, 37, and 38). However, paragraphs 37 and 38 also provide exceptions to those requirements for certain items.
- The special accounting under Statement 133 for a hedging relationship is based on, among other things, measurement of hedge effectiveness, which is subject to alternative treatments and exceptions (paragraphs 22, 30–33, 39, and 41).
- Not only is extensive guidance related to hedged items included in Statement 133 (paragraphs 62–103 of Appendix A and paragraphs 104–175 of Appendix B), additional guidance was provided after Statement 133 was issued through the DIG process. The DIG addressed 21 issues relating to hedging in general (DIG Issues A1–A22) and many more issues relating to specific hedging transactions (fair value hedges, cash flow hedges, and foreign currency hedges).

Under a principles-based approach, the fundamental principles in paragraphs 3(a)–(c) would apply more broadly, requiring that more derivative instruments be recognized and measured at fair value. Further, some believe principle 3(d) to be an exception to a strict principles-based approach, which would not allow hedge accounting. On the other hand, others believe hedge accounting is an appropriate principle. In either case, while the resulting standard would likely require a more expansive definition of derivatives, much of the detail and complexity in Statement 133 might be eliminated. That, in turn, would increase the need for sound professional judgment by preparers and auditors in determining when and how to apply the principles.

REVISED STATEMENT 34

This attachment shows how the standards section of FASB Statement No. 34, *Capitalization of Interest Cost,* might look if developed under a principles-based approach (Revised Statement 34).[7] Attachment C reflects the guidance in Statement 34 that is not retained in the Revised Statement 34. In particular, the Revised Statement 34 does not retain the scope-limiting guidance in paragraphs 9 and 10 of Statement 34, as amended. Instead, it would require professional judgment in determining whether interest capitalization is required for a specific asset based on the cost-benefit considerations discussed in paragraph 46 of Statement 34, which states, "the significance of the effect of interest capitalization in relation to enterprise resources and earnings is the most important consideration in assessing its benefit." Accordingly, for inventory items that are routinely manufactured or otherwise produced in large quantities on a repetitive basis interest, capitalization might not be required under the Revised Statement 34 for cost-benefit reasons. However, it would not be prohibited as under Statement 34.

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[7] As indicated previously, the Revised Statement 34 retains the fundamental principles of Statement 34. The Board did not reconsider those principles or otherwise conclude on whether they would change if Statement 34 were reconsidered currently, for example, as part of an international convergence project.

ORIG ¶ REF	REVISED STATEMENT 34[8]

INTRODUCTION AND OBJECTIVES

1 This Statement establishes standards of financial accounting and reporting for capitalizing interest cost as part of the historical cost of acquiring an asset.

7, 42 The objectives of capitalizing interest cost are:

a. To obtain a measure of acquisition cost consistent with the present accounting model that reflects the enterprise's total investment in the asset. Acquisition cost provides the most reliable measure of cash flow service potential at acquisition. The cash flow potential of an enterprise's assets is significant information in assessing the future net cash flows of the enterprise. A measure of acquisition cost that includes interest cost is likely to be more useful to investors and creditors than one that does not.
b. To charge a cost that relates to the acquisition of a resource that will benefit future periods against the revenues of the periods benefited.

4 Appendix A provides additional background information. Appendix B sets forth the basis for the Board's conclusions.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

N/A Paragraphs in bold type indicate the main principles to be applied under this Statement. Paragraphs in plain type provide additional guidance for applying those principles. However, paragraphs in bold type and plain type have equal authority under this Statement. This Statement need not be applied to immaterial items.

6, 10 **The historical cost of acquiring an asset includes all costs necessarily incurred to bring the asset to the condition and location necessary for its intended use. The term *intended use* embraces both readiness for use and readiness for sale, depending on the purpose of acquisition. If a period of time is required to carry out activities to bring an asset to the condition and location necessary for its intended use (an "acquisition period"), interest cost incurred as a result of expenditures made for the asset during that period shall be capitalized as part of the historical cost of acquiring the asset. The amount of interest capitalized shall not exceed the aggregate expenditures made for the asset during the period.**

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[8] In the Revised Statement 34, the fundamental principles are shown in bold type, separate from additional guidance for applying the principles, which is shown in plain type, as in International Accounting Standards. However, the Board has not yet concluded on whether to adopt that form of presentation.

39, 40	The point in time at which an asset is ready for its intended use is critical in determining its acquisition cost. Some assets are ready for their intended use when purchased. Others are constructed or otherwise developed for a particular use by a series of activities whereby diverse resources are combined to form a new asset or a less valuable resource is transformed into a more valuable resource. Those activities take time. During the period required to complete those activities the expenditures for the materials, labor, and other resources used in creating the asset must be financed. Financing has a cost that, itself, is part of the historical cost of acquiring the asset.
8, 10, 46	**The determination of whether to capitalize interest cost as part of the acquisition cost of an asset is subject to cost-benefit considerations. The significance of the effect of the capitalization of interest cost in relation to enterprise resources and earnings is the most important consideration in assessing its benefit.**
9(a), (b), 46	A favorable balance of the informational benefit and cost of implementation is most likely to be achieved where an asset is constructed or otherwise produced as a discrete project (for example, ships or real estate development) for which costs are separately accumulated and where construction of the asset takes considerable time, entails substantial expenditures, and, thus, is likely to involve a significant amount of interest cost, regardless of whether the asset is intended for an enterprise's own use, sale, or lease. For such assets, capitalization of interest cost is required.
8, 10, 46	A favorable balance of the informational benefit and cost of implementation is not likely to be achieved where assets, such as inventory items, are routinely manufactured or otherwise produced in large quantities on a repetitive basis. For such assets, capitalization of interest cost is not required.
12	**The amount of interest cost to be capitalized is the portion of the interest cost incurred that theoretically could have been avoided during the acquisition period if expenditures for the asset had not been made.**
12, 51	When the decision to acquire the asset is made, the incurrence of interest cost during the acquisition period on existing or additional borrowings is a consequence of that decision. That cause-and-effect relationship between the decision to acquire the asset and the incurrence of interest cost makes interest cost analogous to a direct cost in that circumstance.

13, 14, 52 The amount of interest cost to be capitalized in an accounting period shall be determined by applying a capitalization rate to the average amount of accumulated expenditures for the asset during the period. Capitalization rates shall be based on the rates applicable to borrowings outstanding during the period.

For example:

a. If an enterprise's financing plans associate a specific new borrowing with an asset, the enterprise may use the rate on that borrowing as the capitalization rate to be applied to the portion of the average accumulated expenditures for the asset that does not exceed the amount of that borrowing.
b. If average accumulated expenditures for the asset exceed the amounts of specific new borrowings associated with the asset, the enterprise may use a weighted average of the rates being paid on all borrowings as the capitalization rate to be applied to such excess. In identifying the borrowings to be included in the weighted average rate, the objective is a reasonable measure of the cost of financing the acquisition of the asset in terms of the interest cost incurred that otherwise could have been avoided.

16, 56 Capitalization rates are to be applied to capitalized expenditures (net of progress payment collections) for the asset that have required the payment of cash, the transfer of other assets, or the incurring of liabilities on which interest cost is recognized. Those expenditures exclude amounts corresponding to liabilities on which interest cost is not recognized (such as trade payables, accruals, and retainages).

15 The amount of interest cost capitalized in an accounting period shall not exceed the total amount of interest cost incurred during that period.

17 **The capitalization period shall begin when three conditions are present:**

a. Activities necessary to get the asset ready for its intended use are in progress.
b. Expenditures for the asset are being made.
c. Interest cost is being incurred.

17, 58 Interest capitalization shall continue as long as those three conditions are present.

For example:

a. If acquisition activities are unavoidably delayed by factors inherent in the asset acquisition process or by factors external to the enterprise, interest capitalization shall continue.
b. If acquisition activities are intentionally delayed or otherwise deferred or suspended for some period by the enterprise, interest capitalization shall cease until the enterprise resumes those activities.

18, 61 **The capitalization period shall end when the asset is substantially complete and ready for its intended use.**

For example:

a. If an asset is completed in parts, and each part is capable of being used independently while work is continuing on other parts (for example, a condominium), interest capitalization shall stop on each part when it is substantially complete and ready for use.
b. If an asset must be completed in its entirety before any part of the asset can be used (for example, a facility designed to manufacture products by sequential processes), interest capitalization shall continue until the entire asset is substantially complete and ready for use.
c. If an asset cannot be used effectively until a separate facility has been completed (for example, oil wells drilled in Alaska before completion of the pipeline necessary for the transport of the oil from the wells), interest capitalization shall continue until the separate facility is substantially complete and ready for use.

21(b) **For an accounting period in which interest cost is capitalized, an entity shall disclose in the financial statements or related notes the total amount of interest cost incurred during the period and the amount thereof that has been capitalized.**

GUIDANCE IN STATEMENT 34
NOT RETAINED IN REVISED STATEMENT 34

ORIG ¶ REF	GUIDANCE IN STATEMENT 34 NOT RETAINED IN REVISED STATEMENT 34
1	For the purposes of this Statement, *interest cost* includes interest recognized on obligations having explicit interest rates,[1] interest imputed on certain types of payables in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*, and interest related to a capital lease determined in accordance with FASB Statement No. 13, *Accounting for Leases*.
2	Paragraphs 15 and 16 of Opinion 21 provide that the discount or premium that results from imputing interest for certain types of payables should be amortized as interest expense over the life of the payable and reported as such in the statement of income. Paragraph 12 of Statement 13 provides that, during the term of a capital lease, a portion of each minimum lease payment shall be recorded as interest expense. This Statement modifies Opinion 21 and Statement 13 in that the amount chargeable to interest expense under the provisions of those paragraphs is eligible for inclusion in the amount of interest cost capitalizable in accordance with this Statement.
3	Some enterprises now charge all interest cost to expense when incurred; some enterprises capitalize interest cost in some circumstances; and some enterprises, primarily public utilities, also capitalize a cost for equity funds in some circumstances. This diversity of practice and an observation that an increasing number of nonutility registrants were adopting a policy of capitalizing interest led the Securities and Exchange Commission to impose, in November 1974, a moratorium on adoption or extension of such a policy by most nonutility registrants until such time as the FASB established standards in this area.[2]
9	Interest shall be capitalized for the following types of assets ("qualifying assets"): [Added by FAS 42] c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. [Added by FAS 58]

[1]Interest cost on these obligations includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

[2]Securities and Exchange Commission, ASR No. 163, *Capitalization of Interest by Companies Other Than Public Utilities* (Washington: November 14, 1974).

10 However, interest cost shall not be capitalized for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis because, in the Board's judgment, the informational benefit does not justify the cost of so doing. In addition, interest shall not be capitalized for the following types of assets:

a. Assets that are in use or ready for their intended use in the earning activities of the enterprise
b. Assets that are not being used in the earning activities of the enterprise and that are not undergoing the activities necessary to get them ready for use
c. Assets that are not included in the consolidated balance sheet of the parent company and consolidated subsidiaries [Added by FAS 58]
d. Investments accounted for by the equity method after the planned principal operations of the investee begin [Added by FAS 58]
e. Investments in regulated investees that are capitalizing both the cost of debt and equity capital [Added by FAS 58]
f. Assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that funds are available from such gifts and grants. Interest earned from temporary investment of those funds that is similarly restricted shall be considered an addition to the gift or grant for this purpose. [Added by FAS 62]

11 Land that is not undergoing activities necessary to get it ready for its intended use is not a qualifying asset. If activities are undertaken for the purpose of developing land for a particular use, the expenditures to acquire the land qualify for interest capitalization while those activities are in progress. The interest cost capitalized on those expenditures is a cost of acquiring the asset that results from those activities. If the resulting asset is a structure, such as a plant or a shopping center, interest capitalized on the land expenditures is part of the acquisition cost of the structure. If the resulting asset is developed land, such as land that is to be sold as developed lots, interest capitalized on the land expenditures is part of the acquisition cost of the developed land.

14 Accordingly, judgment will be required to make a selection of borrowings that best accomplishes that objective in the circumstances. For example, in some circumstances, it will be appropriate to include all borrowings of the parent company and its consolidated subsidiaries; for some multinational enterprises, it may be appropriate for each foreign subsidiary to use an average of the rates applicable to its own borrowings. However, the use of judgment in determining capitalization rates shall not circumvent the requirement that a capitalization rate be applied to all capitalized expenditures for a qualifying asset to the extent that interest cost has been incurred during an accounting period.

15 In consolidated financial statements, that limitation shall be applied by reference to the total amount of interest cost incurred by the parent company and consolidated subsidiaries on a consolidated basis. In any separately issued financial statements of a parent company or a consolidated subsidiary and in the financial statements (whether separately issued or not) of unconsolidated subsidiaries and other investees accounted for by the equity method, the limitation shall be applied by reference to the total amount of interest cost (including interest on intercompany borrowings) incurred by the separate entity.

16 However, reasonable approximations of net capitalized expenditures may be used. For example, capitalized costs for an asset may be used as a reasonable approximation of capitalized expenditures unless the difference is material.

17 The term *activities* is to be construed broadly. It encompasses more than physical construction; it includes all the steps required to prepare the asset for its intended use. For example, it includes administrative and technical activities during the preconstruction stage, such as the development of plans or the process of obtaining permits from governmental authorities; it includes activities undertaken after construction has begun in order to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation.

17 Footnote added by FAS 62 stating that in situations involving qualifying assets financed with the proceeds of tax-exempt borrowings that are externally restricted as specified in Statement 62, the capitalization period begins at the date of the borrowing.

19 Interest capitalization shall not cease when present accounting principles require recognition of a lower value for the asset than acquisition cost; the provision required to reduce acquisition cost to such lower value shall be increased appropriately. The provisions of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* apply in recognizing impairment of assets held for use. [Amended by FAS 144]

20 Because interest cost is an integral part of the total cost of acquiring a qualifying asset, its disposition shall be the same as that of other components of asset cost. Interest capitalized on an investment accounted for by the equity method shall be accounted for in accordance with paragraph 19(b) of Opinion 18 which states: "A difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as if the investee were a consolidated subsidiary." [Added by FAS 58]

21 The following information with respect to interest cost shall be disclosed in the financial statements or related notes:

a. For an accounting period in which no interest cost is capitalized, the amount of interest cost incurred and charged to expense during the period.