SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33-8896; 34-57331; File No. 265-24]

Progress Report of the SEC Advisory Committee on Improvements to Financial Reporting.

AGENCY: Securities and Exchange Commission.

ACTION: Request for comments.

SUMMARY: The Advisory Committee is publishing its progress report and is soliciting public comment. The progress report contains the Committee's developed proposals, conceptual approaches, and matters for future considerations on improving the financial reporting system in the United States.

DATES: Comments should be received on or before March 31, 2008.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail message to rule-comments@sec.gov. Please include File Number 265-24 on the subject line.

Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Federal Advisory Committee Management Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549–1090.

All submissions should refer to File No. 265-24. This file number should be included on the subject line if e-mail is used. To help us process and review your comment more efficiently, please use only one method. The Commission will post all comments on its Web site (http://www.sec.gov/about/offices/oca/acifr.shtml). Comments also will be available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Questions about this release should be referred to James L. Kroeker, Deputy Chief Accountant, or Shelly C. Luisi, Senior Associate Chief Accountant, at (202) 551-5300, Office of the Chief Accountant, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6561.

SUPPLEMENTARY INFORMATION: At the request of the SEC Advisory Committee on Improvements to Financial Reporting, the Commission is publishing this release soliciting public comment on the Committee's progress report. The full text of this progress report is attached and also may be found on the Committee's web page at http://www.sec.gov/about/offices/oca/acifr.shtml. The progress report contains the Committee's developed proposals, conceptual approaches, and matters for future considerations on improving the financial reporting system in the United States. This progress report has been approved for issuance by the Committee. It does not necessarily reflect any position or regulatory agenda of the Commission or its staff.

All interested parties are invited to comment on the enclosed progress report. Comments on the progress report are most helpful if they (1) indicate the specific paragraph and/or page number to which the comments relate, (2) contain a clear rationale, and (3) include any alternative(s) the Committee should consider.

AUTHORITY: In accordance with Section 10(a) of the Federal Advisory Committee Act, 5 U.S.C. App. 1, § 10(a), James L. Kroeker, Designated Federal Officer of the Committee, has approved publication of this release at the request of the Committee. The solicitation of comments is being made solely by the Committee and not by the Commission. The Commission is merely providing its facilities to assist the Committee in soliciting public comment from the widest possible audience.

Nancy M. Morris
Committee Management Officer

Dated: February 14, 2008

Appendix

PROGRESS REPORT
of the
ADVISORY COMMITTEE
on IMPROVEMENTS to
FINANCIAL REPORTING
to the
UNITED STATES SECURITIES and EXCHANGE COMMISSION

February 14, 2008

Progress Report
of the
Advisory Committee
on Improvements to Financial Reporting
to the
United States Securities and Exchange Commission

TABLE OF CONTENTS

SEC ADVISORY COMMITTEE ON IMPROVEMENTS TO FINANCIAL REPORTING

Washington, DC 20549

February 14, 2008

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1070

Dear Chairman Cox:

It is my pleasure and privilege to present to you, and the other Commissioners, on behalf of the Advisory Committee on Improvements to Financial Reporting, a progress report of the Committee's developed proposals, conceptual approaches, and currently identified matters for future consideration.

Our Committee has worked diligently to provide an interim progress report to you. The developed proposals in our progress report are proposals that we believe could be implemented by the Commission, its staff, or other bodies, as appropriate. These 12 proposals are summarized in the executive overview of our progress report. Conceptual approaches represent our initial views, which are based on discussions on a particular subject, but which require additional vetting before formalization into a developed proposal. Matters for future consideration are areas in which deliberations and research have not yet begun. After the conclusion of the Committee's work later this year, we will issue a final report with written recommendations.

We commend the Commission for its initiative in creating the Committee. You have been generous in furnishing staff and other resources. We would like to thank the staff members whose participation was invaluable during this phase of the Committee's work. These include from the Commission staff:

Conrad Hewitt
John W. White
James Daly
Bert Fox
Stephanie Hunsaker
Nili Shah
Brett Williams
James Kroeker
Wayne Carnall
Adam Brown
Todd E. Hardiman
Shelly Luisi
Amy Starr

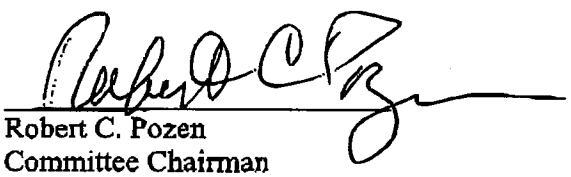
These also include Russell Golden, Holly Barker and Christopher Roberge from the Financial Accounting Standards Board and Sharon Virag from the Public Company Accounting Oversight Board.

We also want to thank our Official Observers whose participation and counsel have been invaluable to the Committee during this time:

Robert Herz	Charles Holm
Kristen Jaconi	Phil Laskawy
Mark Olson	

We look forward to working with the Committee staff and Official Observers in the coming months as we develop our final report and recommendations.

Respectfully submitted on behalf of the Committee,



Robert C. Pozen
Committee Chairman

cc: Commissioner Paul S. Atkins
Commissioner Kathleen L. Casey
Members and Official Observers of the Committee
Conrad Hewitt
John White
James L. Kroeker
Nancy M. Morris

EXECUTIVE OVERVIEW[1]

In July 2007, the U.S. Securities and Exchange Commission (SEC or Commission) chartered the Advisory Committee on Improvements to Financial Reporting (Committee). The Committee's assigned objective is to examine the U.S. financial reporting system in order to make recommendations intended to increase the usefulness of financial information to investors,[2] while reducing the complexity of the financial reporting system to investors, companies, and auditors.

After the conclusion of our work, we will issue a final report with written recommendations to the Chairman of the SEC. In order to maximize our effect, we intend to issue a limited number of focused recommendations that address acknowledged problem areas and that we believe can be adopted without legislation, rather than attempting to address all perceived shortcomings in the financial reporting system.

All Committee members present at our February 11, 2008 meeting voted unanimously to issue to the Chairman of the SEC this progress report of the Committee's developed proposals, conceptual approaches, and currently identified matters for future consideration and to publish the progress report in order to encourage public feedback. Developed proposals are proposals that we believe could be implemented by the Commission, its staff,[3] or other bodies, as appropriate; these are summarized in the second part of this executive overview. Conceptual approaches represent our initial views, which are based on discussions on a particular subject, but which still require additional vetting before formalization into a developed proposal. Matters for future consideration are areas in which deliberations and research have not yet begun.

This progress report represents our work to date, which has included four public meetings where these topics were deliberated by the full Committee. In generating this progress report, we also considered all of the public comments received to date on our work.[4] All of the developed proposals, conceptual approaches and matters for future consideration were adopted unanimously (except for one dissenting vote on one proposal, as noted herein, which resulted in one separate statement from Mr. Wallison, attached as appendix A of this progress report).

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[1] This report has been approved by the Committee and reflects the views of a majority of its members. It does not necessarily reflect any position or regulatory agenda of the Commission or its staff.

[2] The term "investor(s)" is used throughout this progress report to refer to investors, creditors, rating agencies, and other users.

[3] We note that some of our developed proposals, conceptual approaches, and matters for future considerations may require SEC action, while others may be implemented by SEC staff. We have, however, generally adopted a convention of addressing these areas to the SEC for convenience. We leave the determination of whether the proposals require SEC or SEC staff action to the discretion of the SEC and its staff.

[4] Comments to the Committee are available at http://www.sec.gov/comments/265-24/265-24.shtml. We have and continue to welcome feedback at any time from investors, registrants, auditors, and others on our work. Information on how to submit comments is available at http://www.sec.gov/about/offices/oca/acifr.shtml.

We explain each of our developed proposals, conceptual approaches and matters for future consideration in the body of this progress report. The progress report is organized by the topics considered by the four subcommittees that were created in order to research, develop, and propose preliminary recommendations to the full Committee for discussion and decision-making. Thus, chapter one is on substantive complexity; chapter two on the standards-setting process; chapter three on audit process and compliance; and chapter four on delivery of financial information. Later in 2008, we will also identify and analyze some of the issues involved with the potential movement from a U.S.-based accounting regime to a global accounting system.

This executive overview highlights the key themes that tie together the chapters in this progress report, with a few examples to illustrate each theme.[5] The main themes are:

1. Increasing emphasis on the investor perspective in the financial reporting system
2. Consolidating the process of setting and interpreting accounting standards
3. Promoting the design of more uniform and principles-based accounting standards
4. Creating a disciplined framework for the increased use of professional judgment
5. Taking steps to coordinate generally accepted accounting principles in the U.S. (GAAP) with international financial reporting standards (IFRS).

I. Themes

I.A. Investor Perspective

The current system of financial reporting, including the process by which financial reporting standards are developed, attempts to balance the interests of relevant parties such as preparers, auditors, and investors. In practice, however, the system has sometimes been more responsive to the interests of preparers and auditors than to the needs of investor groups.

We believe that the financial reporting system should give pre-eminence to the needs of investors, while not ignoring the interests of other relevant parties. In this regard, we propose that investors be better represented on the Financial Accounting Standards Board (FASB) and the Financial Accounting Foundation (FAF). We also propose that the determination of how to correct financial statement errors should be based on the needs of current investors, who should, in any event, be provided with more disclosure regarding such errors.

With regard to the delivery of financial information, we propose that the SEC clarify certain legal issues related to the use of company websites as a vehicle for providing useful information to different types of investors in order to facilitate creative methods to present such information, such as in tiered formats. We also propose a gradual phase-in

[5] We wish to emphasize that the examples we give are illustrative only. We do not mean to imply any order of priority.

of interactive disclosure technology (i.e., XBRL-tagging) to facilitate the ability of investors to more easily access comparative arrays of company information, while minimizing the burdens on preparers (especially smaller companies). A phase-in approach would allow for enhanced understanding of the technology, proven use of the new XBRL U.S. GAAP Taxonomy, and further development of tagging and rendering software.

I.B. Setting Standards and Interpretative Process

The current financial reporting system is characterized by a large volume of standards, including individual standards that are too long or complicated; interpretations; and detailed application guidance from a variety of public and private sources. This volume and complexity have led to concerns about whether the FASB is following appropriate priorities within a consistent conceptual framework in adopting standards, and whether investors, preparers, and auditors can efficiently find the complete body of authoritative literature on an accounting issue.

While the FASB has made considerable progress in addressing both concerns, we believe that certain measures are needed to enhance the process for adopting new standards and issuing interpretations of existing standards.[6] For example, we propose that the FASB should set explicit priorities based on consultation with an Agenda Advisory Group, which would include representatives of the SEC and the Public Company Accounting Oversight Board (PCAOB), as well as representatives from the investor, preparer, and auditor communities. Further, the FASB should fully explain and expose for comment, in documents containing proposed significant new standards, its process for conducting cost-benefit studies, including field interviews and testing before finalizing any significant new accounting standard. Also, we propose that the FASB, with input from the Agenda Advisory Group, should conduct periodic assessments of existing standards to determine if they are operating as intended.

With the implementation of these proposals, we propose that the FASB should be, to the extent practicable, the sole standards-setter for GAAP and the primary source of broad interpretations of existing accounting standards. The FASB should perform these functions with a high degree of independence, but it should coordinate closely with the SEC, including through the proposed Agenda Advisory Committee. When it is necessary for the SEC to issue broadly applicable interpretations, we are considering the manner in which the SEC develops and communicates those interpretations. Nevertheless, we believe the SEC should continue to provide comments on registrant-specific matters, but these comments should not be viewed as broadly applicable. We propose that the

[6] We recognize that the FASB has processes that are moving in the direction of the objectives underlying our interim developed proposals. We look forward to further discussion with the FASB to evaluate whether additional improvements would more effectively achieve the desired objectives. We plan to consider this dialogue in making final recommendations for process enhancements to the U.S. standards-setter.

authoritative source of GAAP should be limited, as much as possible, to the contents of the FASB's codification project, which will be updated on a regular basis.

I.C. Design of Standards

GAAP contains many detailed rules with several industry-specific exceptions and alternative accounting policies for the same transaction. Moreover, some of these rules have all-or-nothing results, which stem from bright line tests. This combination allows companies and auditors to reach a technically compliant conclusion that may be inconsistent with the underlying economic substance of the transaction, thereby potentially undermining an investor's complete and accurate understanding of the transaction. For example, transactions involving the right to use an asset for a promise to pay a series of payments in the future can be kept off a company's balance sheet if detailed rules are followed.

In response, we propose that the FASB move away from industry-specific guidance to activity-based guidance (e.g., from banking as an industry to lending as an activity by any company) and strive to reduce the number of alternative ways available under GAAP to account for the same transaction. We also plan to consider, among other possibilities, the feasibility of proportionate recognition, rather than all-or-nothing results, to better reflect the rights conveyed by agreements and obligations incurred.

Some believe an increased use of fair value measurements will better portray the current valuation of past transactions and improve financial reporting. Others believe the increased use of fair value measurements will cause unnecessary volatility, will decrease the reliability of financial statements, and will only increase investor confusion. We plan to deliberate whether, among other approaches, to support the FASB's project to consider changing the income statement format into two or more groupings designed to help investors better understand the different sources of changes in a company's income – for example, by separating cash or accrued earnings from changes resulting from fluctuations in the fair value of assets such as publicly-traded bonds.

More broadly, we will consider recommending that the FASB design accounting standards with more general principles and fewer detailed rules in order to prevent the manipulation of technical requirements to reach pre-conceived accounting results.

I.D. Professional Judgment

The preparation and audit of financial statements have always required the use of judgment. The recent evolution of accounting requires even more judgment – for example, the more frequent use of fair value involves estimates of value that may be less objectively determined than historical cost measures. Similarly, the revised auditing standards recently issued by the PCAOB emphasize the need for professional judgment in taking a risk-based approach to performing internal control audits.

As noted above, we are about to study the merits of moving in the direction of more principles and fewer detailed rules. Also, as mentioned below, international accounting standards, as they exist today, contain less detailed guidance and fewer rules than GAAP. Detailed rules not only increase the complexity of the financial reporting system, but they also permit the structuring of transactions to achieve a particular accounting result, even if the results are inconsistent with the economic substance of the transactions or the underlying purposes of the rules.

In recognition of the increasing use of accounting judgment, we are making two developed proposals. First, we propose asking the FASB to conduct post-adoption reviews of significant new standards, generally within one to two years of their effective dates to ascertain the degree of diversity in practice in using judgment when applying those standards. If that diversity is too broad or otherwise inappropriate, we would expect the FASB to amend the standard or issue interpretative guidance.

Second, we propose that the SEC and PCAOB adopt frameworks for reviewing the exercise of judgment. The framework applicable to accounting judgments would require a disciplined process, including the identification of available alternatives, analysis of the relevant literature, review of the pertinent facts, and a well-reasoned explanation of the conclusions – all documented contemporaneously with the making of the accounting judgment. We believe adoption of these frameworks would encourage executives and auditors to follow a disciplined process in making judgments, and thereby give investors more confidence in the ways in which accounting and auditing judgments are being exercised.

I.E. Global Convergence

At present, U.S. companies follow GAAP; in most other countries, publicly-traded companies are increasingly following IFRS as adopted by the International Accounting Standards Board (IASB). We support the long-term goal of converging GAAP with IFRS in order to reduce accounting costs to investors and others in an increasingly global business environment. But we recognize that there are various paths to convergence, and it may take years for full convergence to be achieved. Therefore, we believe that it is quite useful to propose enhancements to the financial reporting system in the U.S.

Later in 2008, we will identify and analyze some of the issues to be resolved in the move toward global convergence of accounting standards. At this time, we note that the principles contained in IFRS are less encumbered by detailed rules than GAAP; accordingly, GAAP will probably need to become less rules-based in order to promote the goal of global convergence. We also note that IFRS has little industry-specific guidance, and we encourage the IASB to continue in this manner, consistent with our proposal that the FASB issue activity-based standards rather than industry-specific accounting standards.

On the other hand, IFRS contains a number of alternative accounting policies for the same activity, and there are political pressures to add exceptions in certain countries. As

part of the effort to promote global convergence, we urge the IASB to continue to reduce the number of alternative accounting policies currently available and to resist the political pressures for country exceptions.

II. Summary of Developed Proposals

Summarized below are our developed proposals based on our work to date. These developed proposals are discussed in greater detail in the remainder of this progress report. These developed proposals are numbered consecutively in this executive overview, with a reference in parentheses to their position in the body of the report.

1. GAAP should be based on business activities,[7] rather than industries. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB be scoped on the basis of business activities rather than industries. Any new projects should include the elimination of existing industry-specific guidance in relevant areas as a specific objective of those projects, unless, in rare circumstances, retaining industry guidance can be justified on the basis of cost-benefit considerations (discussed in section II.A of chapter 1).

   The SEC should also recommend that, in conjunction with its current codification project, the FASB add a project to its agenda to remove or minimize existing industry-specific guidance that conflicts with generalized GAAP, taking into account the pace of convergence efforts.[8] (Chapter 1 – developed proposal 1.1)

2. GAAP should be based on a presumption that formally promulgated alternative accounting policies should not exist. The SEC should recommend that any new projects undertaken jointly or separately by the FASB not provide additional optionality, unless, in rare circumstances, it can be justified. Any new projects should include the elimination of existing alternative accounting policies in relevant areas as a specific objective of those projects, unless, in rare circumstances, the optionality can be justified. (Chapter 1 – developed proposal 1.2)

3. Additional investor representation on standards-setting bodies is central to improving financial reporting. Only if investor perspectives are properly considered by all

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[7] As discussed in section II.B of chapter 1 regarding management intent, we have not taken a position as to whether intent is an appropriate basis of accounting. Similarly, we express no view on whether intent provides a meaningful distinction between business activities.

[8] Some constituents understand "convergence" to mean that GAAP and IFRS (as published by the IASB) will eventually be harmonized, at which point no substantive differences will exist between the two bodies of accounting literature. Others understand it to mean a discrete transition from GAAP to IFRS at a specified date without respect to whether the two bodies of literature are substantially harmonized. The timing of these two approaches may differ, which would likely impact the prioritization of this proposal to eliminate existing U.S. industry-specific guidance on the FASB's agenda. In either case, we believe industry-specific guidance should be substantially eliminated prior to convergence – either as a component of the convergence plan, or by establishing a specified date after which the use of industry-specific guidance would be prohibited.

parties will the output of the financial reporting process meet the needs of those for whom it is primarily intended to serve. Therefore, the perspectives of investors should have pre-eminence. To achieve that pre-eminence in standards-setting, the SEC should encourage the following improvements:

- Add investors to the FAF to give more weight to the views of different types of investors, both large and small
- Give more representation on both the FASB and the FASB staff to experienced investors who regularly use financial statements to make investment decisions to ensure that standards-setting considers fully the usefulness of the resulting information. (Chapter 2 – developed proposal 2.1)

4. The SEC should assist the FAF with enhancing its governance of the FASB, as follows:
   - By encouraging the FAF to develop performance metrics to assess the FASB's adherence to the goals in its mission statement, objectives, and precepts and to improve its efficiency
   - By supporting the FAF's changes outlined in its *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB*, with minor modifications regarding composition of the FAF and the FASB, as proposed in section II of chapter 2, and agenda-setting, as proposed in section IV of chapter 2
   - By encouraging the FAF to amend the FASB's mission statement, stated objectives, and precepts to emphasize that an additional goal should be to minimize avoidable complexity. (Chapter 2 – developed proposal 2.2)

5. The SEC should encourage the FASB to further improve its standards-setting process and timeliness, as follows:
   - Create a formal Agenda Advisory Group that includes strong representation from investors, the SEC, the PCAOB, and other constituents, such as preparers or auditors, to make recommendations for actively managing U.S. standards-setting priorities
   - Refine procedures for issuing new standards by: (1) implementing investor pre-reviews designed to assess perceived benefits to investors, (2) enhancing cost-benefit analyses, and (3) requiring improved field visits and field tests
   - Improve review processes for new standards by conducting post-adoption reviews of every significant new standard, generally within one to two years of its effective date, to address interpretive questions and reduce the diversity of practice in applying the standard, if needed
   - Improve processes to keep existing standards current and to reflect changes in the business environment by conducting periodic assessments of existing standards. (Chapter 2 – developed proposal 2.3)

6. The number of parties that either formally or informally interprets GAAP and the volume of interpretative implementation guidance should continue to be reduced. The SEC should coordinate with the FASB to clarify roles and responsibilities regarding the issuance of interpretive implementation guidance, as follows:

- The FASB Codification, a draft of which was released for verification on January 16, 2008, should be completed in a timely manner. In order to fully realize the benefits of the FASB's codification efforts, the SEC should ensure that the literature it deems to be authoritative is integrated into the FASB Codification to the extent possible, or separately re-codified, as necessary.
- To the extent practical, going forward, there should be a single standards-setter for all authoritative accounting standards and interpretive implementation guidance that are applicable to a particular set of accounting standards, such as GAAP or IFRS. For GAAP, the FASB should continue to serve this function. To that end, the SEC should only issue broadly applicable interpretive implementation guidance in limited situations (see section VI of chapter 2).
- All other sources of interpretive implementation guidance should be considered non-authoritative and should not be required to be given more credence than any other non-authoritative sources that are evaluated using well-reasoned, documented professional judgments made in good faith. (Chapter 2 – developed proposal 2.4)

7. The FASB or the SEC, as appropriate, should issue guidance reinforcing the following concepts:
   - Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor.
   - Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor.
   - Just as qualitative factors may lead to a conclusion that a quantitatively small error is material, qualitative factors also may lead to a conclusion that a quantitatively large error is not material. The evaluation of errors should be on a "sliding scale."

   The FASB or the SEC, as appropriate, should also conduct both education sessions internally and outreach efforts to financial statement preparers and auditors to raise awareness of these issues and to promote more consistent application of the concept of materiality. (Chapter 3 – developed proposal 3.1)

8. The FASB or the SEC, as appropriate, should issue guidance on how to correct an error consistent with the principles outlined below:
   - Prior period financial statements should only be restated for errors that are material to those prior periods.
   - The determination of how to correct a material error should be based on the needs of current investors. For example, a material error that has no relevance to a current investor's assessment of the annual financial statements would not require restatement of the annual financial statements in which the error occurred, but would need to be disclosed in an appropriate document, and, to the extent that the error remains uncorrected in the current period, corrected in the current period.
   - There may be no need for the filing of amendments to previously filed annual or interim reports to reflect restated financial statements, if the next annual or

interim period report is being filed in the near future and that report will contain all of the relevant information.

- Restatements of interim periods do not necessarily need to result in a restatement of an annual period.
- All errors, other than clearly insignificant errors, should be corrected no later than in the financial statements of the period in which the error is discovered. All material errors should be disclosed when they are corrected.
- The current disclosure during the period in which the restatement is being prepared, about the need for a restatement and about the restatement itself, is not consistently adequate for the needs of investors and should be enhanced. (Chapter 3 – developed proposal 3.2)

9. The FASB or the SEC, as appropriate, should develop and issue guidance on applying materiality to errors identified in prior interim periods and how to correct these errors. This guidance should reflect the following principles:
   - Materiality in interim period financial statements must be assessed based on the perspective of the reasonable investor
   - When there is a material error in an interim period, the guidance on how to correct that error should be consistent with the principles outlined in developed proposal 8 above. (Chapter 3 – developed proposal 3.3)

10. The SEC should adopt a judgment framework for accounting judgments. The PCAOB should also adopt a similar framework with respect to auditing judgments. Careful consideration should be given in implementing any framework to ensure that the framework does not limit the ability of auditors and regulators to ask appropriate questions regarding judgments and take actions to require correction of unreasonable judgments.

    The proposed framework applicable to accounting-related judgments would include the choice and application of accounting principles, as well as the estimates and evaluation of evidence related to the application of an accounting principle. We believe that a framework that is consistent with the principles outlined in this developed proposal to cover judgments made by auditors based on the application of PCAOB auditing standards would be very important and would be beneficial to investors, preparers, and auditors. Therefore, we propose that the PCAOB develop a professional judgment framework for the application and evaluations of judgments made based on PCAOB auditing standards. (Chapter 3 – developed proposal 3.4)

11. The SEC should, over the long-term, mandate the filing of XBRL-tagged financial statements after the satisfaction of certain preconditions relating to: (1) successful XBRL U.S. GAAP Taxonomy testing, (2) capacity of reporting companies to file XBRL-tagged financial statements using the new XBRL U.S. GAAP Taxonomy on the SEC's EDGAR system, and (3) the ability of the EDGAR system to provide an accurately rendered version of all such tagged information. The SEC should phase-in XBRL-tagged financial statements as follows:

- The largest 500 domestic public reporting companies based on unaffiliated market capitalization (public float) should be required to furnish to the SEC, as is the case in the voluntary program today, a document prepared separately from the reporting companies' financial statements that are filed as part of their periodic Exchange Act reports. This document would contain the following:
  - XBRL-tagged face of the financial statements[9]
  - Block-tagged footnotes to the financial statements.[10]

- Domestic large accelerated filers (as defined in SEC rules, which would include the initial 500 domestic public reporting companies) should be added to the category of companies, beginning one year after the start of the first phase, required to furnish XBRL-tagged financial statements to the SEC.

- Once the preconditions noted above have been satisfied and the second phase-in period has been implemented, the SEC should evaluate whether and when to move from furnishing to the SEC to the official filing of XBRL-tagged financial statements with the SEC for the domestic large accelerated filers, as well as the inclusion of all other reporting companies, as part of a company's Exchange Act periodic reports. (Chapter 4 – developed proposal 4.1)[11]

12. The SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information, which addresses issues such as liability for information presented in a summary format, treatment of hyperlinked information from within or outside a company's website, treatment of non-GAAP disclosures and GAAP reconciliations, and clarification of the public availability of information disclosed on a reporting company's website.

    Industry participants should coordinate among themselves to develop uniform best practices on uses of corporate websites for delivering corporate information to investors and the market. (Chapter 4 – developed proposal 4.2)

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We believe publication of this progress report will increase the chances of our recommendations being implemented. The developed proposals in this progress report are described with enough detail to enable the SEC and public commentators to evaluate whether regulatory action in these areas is warranted. The description of conceptual approaches in this progress report will hopefully stimulate discussion and debate on these topics so that we can put forward additional developed proposals later this year.

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[9] To allow this first phase, the SEC EDGAR system must permit submissions using the new XBRL U.S. GAAP Taxonomy.

[10] We understand that tagging beyond the face of the financial statements and block-tagging of footnotes, such as granular tagging of footnotes and non-financial data, may require significant effort and would involve a significant number of tags.

[11] A dissenting vote on developed proposal 4.1 was cast by Peter Wallison.

INTRODUCTION[12]

I. Our Objective

In July 2007, the U.S. Securities and Exchange Commission (SEC or Commission) chartered the Advisory Committee on Improvements to Financial Reporting (Committee). The Committee's assigned objective is to examine the U.S. financial reporting system in order to make recommendations intended to increase the usefulness of financial information to investors,[13] while reducing the complexity of the financial reporting system to investors, companies, and auditors.

More specifically, our charter identifies the following areas of inquiry:

- The current approach to setting financial accounting and reporting standards, including: (1) the principles-based versus rules-based standards, (2) the inclusion within standards of exceptions, bright lines, and safe harbors, and (3) the process for providing timely guidance on implementation issues and emerging issues
- The current process of regulating compliance with accounting and reporting standards
- The current system for delivering financial information to investors and accessing that information
- Other environmental factors that drive avoidable complexity, including the possibility of being second-guessed, the structuring of transactions to achieve an accounting result, and whether there is a hesitance by professionals to exercise professional judgment in the absence of detailed rules
- Whether there are current accounting and reporting standards that do not result in useful information to investors, or impose costs that outweigh the resulting benefits
- Whether the growing use of international accounting standards has an impact on the relevant issues relating to the complexity of U.S. accounting and reporting standards and the usefulness of the U.S. financial reporting system.

II. Our Guiding Principles

We believe that financial reporting should provide information that aids investors in making investment, credit, and similar resource allocation decisions.[14] However, some argue that, over time, financial reporting has become a burdensome compliance exercise with decreasing relevance to investors. This effect can be attributed, in part, to: (1) the evolution of new business strategies and financing techniques that stretch the limits of

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[12] This report has been approved by the Committee and reflects the views of a majority of its members. It does not necessarily reflect any position or regulatory agenda of the Commission or its staff.

[13] The term "investor(s)" is used throughout this progress report to refer to investors, creditors, rating agencies, and other users.

[14] Adapted from the FASB Preliminary Views document and IASB Discussion Paper, *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information* (July 6, 2006), which states, "The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions."

what the traditional reporting framework can effectively convey, and (2) an overly litigious culture that, arguably, results in financial reporting designed as much to protect against liability as to inform investors. As a result, we believe the disconnect between current financial reporting and the information necessary to make sound investment decisions has become more pronounced.

A key factor often cited as driving this disconnect is complexity, which has rarely been defined in the context of financial reporting. We have developed and applied the following definition of complexity in this context to guide our deliberations:

Definition of Complexity

The state of being difficult to understand and apply. Complexity in financial reporting refers primarily to the difficulty for:

1. Investors to understand the economic substance of a transaction or event and the overall financial position and results of a company
2. Preparers to properly apply generally accepted accounting principles in the U.S. (GAAP) and communicate the economic substance of a transaction or event and the overall financial position and results of a company
3. Other constituents to audit, analyze, and regulate a company's financial reporting.

Complexity can impede effective communication through financial reporting between a company and its stakeholders. It also creates inefficiencies in the marketplace (e.g., increased investor, preparer, audit, and regulatory costs) and suboptimal allocation of capital.

Causes of Complexity

The causes of complexity are many and varied. We have identified the following significant causes of complexity:

1. Complex activities – The increasingly sophisticated nature of business transactions can be difficult to understand, particularly with respect to the growing scale and scope of companies with operations that cross international boundaries and financial reporting regimes
2. Incomparability and inconsistency – Incomparable reporting of activities within and across entities arises because of factors such as exceptions to general principles, bright lines, and the mixed attribute model. Some of this guidance permits the structuring of transactions in order to achieve particular financial reporting results. Further, to the extent new pronouncements are adopted prospectively, past and present periods of operating results are not comparable. This is compounded by the rapid pace at which new accounting pronouncements are being adopted, which hinders the ability of all constituents to understand and apply new guidance in relatively short timeframes.
3. Nature of financial reporting standards – Standards can be difficult to understand and apply for several reasons, including:

- The existence of opposing points of view that were taken into account when developing standards – most importantly, the attempts by public companies to smooth amounts that vary from period to period, versus the requests from those who want such amounts marked to market each period.
- The challenge of describing accounting principles in simple terms (i.e., plain English) for highly sophisticated transactions
- The presence of detailed guidance for numerous specific fact patterns
- The impact of multiple bodies setting standards
- The development of such standards on the basis of an incomplete and inconsistent conceptual framework.

4. Volume – The vast number of formal and informal accounting standards, regulations, and interpretations, including redundant requirements, make finding the appropriate standard or interpretation challenging for particular fact patterns.
5. Audit and regulatory systems that challenge the use of professional judgment – The risk of litigation and the fear of being "second-guessed" results in (1) a greater demand for detailed rules on how to apply accounting standards to an ever increasing set of specific situations, (2) unnecessary restatements that are not meaningful to investors, and (3) legalistic disclosures that are difficult to understand.
6. Educational shortcomings – Undergraduate and graduate education in accounting has traditionally emphasized the mechanics of double-entry bookkeeping, which favors the use of detailed rules rather than the full understanding of relevant principles. The same approach is evident in the certified public accountant exam, as well as continuing professional education requirements.
7. Information delivery – The need for information varies by investor type and is often driven by a legal, rather than an investor, perspective. In addition, the amount and timing of information, as well as the method by which it is transmitted, may result in complex and hard-to-navigate disclosures that cause investors to sort through material that they may not find relevant in order to identify pieces that are. These factors make it difficult to distinguish the sustaining elements of an entity from non-operating or other influences.

We observe that two types of substantive complexity exist: (1) unavoidable complexity, which is a function of the underlying transaction or item being accounted for, such as the first cause of complexity noted above, and (2) avoidable complexity, which is introduced from other sources. Our focus is on avoidable complexity, with an emphasis on improvements that are feasible in the near-term.

III. Our Scope

We have limited our deliberations to matters involving SEC registrants. While financial reporting matters and, more specifically, GAAP, also apply to private entities, including nonprofit organizations, our focus is consistent with our role as an advisory committee to the SEC.

We have also focused our scope as it relates to international matters. The SEC recently amended its rules to eliminate the requirement for a GAAP reconciliation for foreign private issuers reporting under international financial reporting standards (IFRS) as issued by the International Accounting Standards Board (IASB), and issued a concept release to explore a more far-reaching prospect – the possibility of giving domestic issuers the alternative to report using IFRS. We have proceeded based on two premises: (1) that, despite any potential actions by the Commission to permit IFRS reporting by domestic issuers, GAAP will continue to be utilized by many U.S. public companies for a significant number of years, and (2) that the convergence process between GAAP and IFRS will continue. As a result, we believe it is productive to make recommendations on improving GAAP, as well as the related processes at the Financial Accounting Standards Board (FASB or the Board), the Public Company Accounting Oversight Board (PCAOB), and the SEC. At the same time, we will point out how our developed proposals can be coordinated with the work of the IASB and the development of IFRS, with the objective of promoting convergence.

IV. Our Approach

After the conclusion of our work, we will issue a final report with written recommendations to the Chairman of the SEC. In order to maximize our effect, we intend to issue a limited number of focused recommendations that address acknowledged problem areas and that we believe can be adopted without legislation, rather than attempting to address all perceived shortcomings in the financial reporting system.

To facilitate the development of these recommendations, we have created subcommittees that report to the full Committee for discussion and deliberation. The subcommittees are:

1. Substantive Complexity
2. Standards-Setting Process
3. Audit Process and Compliance
4. Delivering Financial Information

Matters related to international coordination will be addressed, as appropriate, as part of our deliberations later in 2008.

The purpose of this progress report is to present our developed proposals, conceptual approaches, and matters for future considerations based on the our work to date. Developed proposals are proposals that we believe could be implemented by the Commission, its staff,[15] or other bodies, as appropriate. Conceptual approaches represent our initial views, which are based on discussions on a particular subject, but which still

[15] We note that some of our developed proposals, conceptual approaches, and matters for future considerations may require SEC action, while others may be implemented by SEC staff. We have, however, generally adopted a convention of addressing these areas to the SEC for convenience. We leave the determination of whether the proposals require SEC or SEC staff action to the discretion of the SEC and its staff.

require additional vetting before formalization into a developed proposal. Matters for future considerations are areas in which deliberations and research have not yet begun.

Our work to date has included four public meetings where these topics were deliberated by the full Committee. In generating this progress report, we also considered all of the public comments received to date on our work.[16] All of the developed proposals, conceptual approaches and matters for future consideration were adopted unanimously (except for one dissenting vote on one proposal, as noted herein, which resulted in one separate statement from Mr. Wallison, attached as appendix A of this progress report).

[16] Comments to the Committee are available at http://www.sec.gov/comments/265-24/265-24.shtml. We have and continue to welcome feedback at any time from investors, registrants, auditors, and others on our work. Information on how to submit comments is available at http://www.sec.gov/about/offices/oca/acifr.shtml.

CHAPTER 1: SUBSTANTIVE COMPLEXITY

I. Introduction

Public companies in the U.S. submit financial statements to the SEC so investors can monitor their financial performance and make decisions about capital allocation. Traditionally, those financial statements are prepared using a common framework referred to as GAAP. A casual review of audited financial statements might create a perception that amounts reported in a balance sheet or income statement are mechanical and precise, when they in fact reflect a great deal of choices, estimation and judgment.

While ideally GAAP should provide clear and consistent guidance for preparing financial statements, this is not always true. A number of factors undermine this ideal, including the causes of complexity enumerated in the Introduction to this progress report. As a result, certain parts of GAAP may actually hinder effective comparison of financial performance between companies. For instance, a large company may purchase a smaller company to acquire a newly-developed patent that the smaller company obtained to protect a promising new product. In that scenario, the purchasing company would record the patent as an asset under GAAP. However, if the smaller company was not purchased, but continued developing the product on its own, it would be prohibited by GAAP from recording an asset to reflect the patent on its balance sheet.

This example is just one illustration of the avoidable complexity embedded in the current substantive standards of GAAP. We have identified what we consider to be the three most pressing forms of avoidable substantive complexity that currently exist in financial reporting: (1) exceptions to general principles, (2) bright lines, and (3) the mixed attribute model that blends the use of fair value and historical cost.

Exceptions to general principles create complexity because they deviate from established standards that are applicable to most companies. In effect, investors and preparers no longer speak a uniform language to communicate financial information; they must learn new dialects. Other constituents in that communication process are similarly impacted. Our work in this area is divided into four categories. First, there are many examples of industry-specific guidance, some of which conflict with more generalized GAAP that applies across most industries.[17] Second, alternative accounting policies give preparers options among acceptable practices, such as whether or not to apply hedge accounting,[18] which reduce comparability across companies. Third, scope exceptions other than industry-specific guidance represent departures from a principle and require detailed analyses to determine whether they apply. Fourth, competing models create requirements to apply different accounting models to similar types of transactions or events, depending

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[17] See comparison of Statement of Financial Accounting Standard (SFAS) No. 51, *Financial Reporting by Cable Television Companies*, with SEC Staff Accounting Bulletin (SAB) 104, *Revenue Recognition* (as codified in SAB Topic 13), later in this chapter.

[18] Hedge accounting guidance is provided in SFAS No. 133, *Accounting for Derivatives and Hedging Activities.*

on the balance sheet or income statement items involved. This diversity requires all constituents to understand assorted implementation methods, even though they are based on similar fundamental principles.

Bright lines are problematic because they create superficial borders along a continuous spectrum of transactions. More fundamentally, certain reporting standards require drastically different accounting treatments on either side of a bright line. Lease accounting is often cited as an illustration of bright lines. Consider, for example, a lessee's accounting for a piece of machinery. Under current requirements, the lessee will account for the lease in one of two significantly different ways: either (1) reflect an asset and a liability on its balance sheet, as if it owns the leased asset or (2) reflect nothing on its balance sheet. The accounting conclusion depends on the results of two quantitative tests,[19] where a mere 1% difference leads to very different accounting.

The mixed attribute model results in amounts that are a blend of accounting conventions. Some assets and liabilities are measured at historic cost, others at lower of cost or market, and still others at fair value. Combinations or subtotals of these numbers thus may not be intuitively useful to investors. While some advocate using fair value for the entire balance sheet as a solution, this would exacerbate the existing questions about relevance and reliability, including considerable subjectivity in the valuation of thinly-traded assets and liabilities.

The remainder of this chapter discusses each of these areas and the manner in which they contribute to complexity in greater depth. It also contains developed proposals or conceptual approaches to reduce their effects. The sequence in which these areas are presented does not necessarily indicate their relative priority to one another. Rather, certain areas warrant additional research and deliberation before reasonable proposals can be fully developed, such as those related to the mixed attribute model and more meaningful groupings of individual line items on the financial statements. We intend to pursue these topics during the course of our work later in 2008. Lastly, while deliberations have been conducted primarily in the context of GAAP, we believe that our analyses and proposals are similarly applicable under IFRS.

II. Exceptions to General Principles

II.A. Industry-Specific Guidance

Developed Proposal 1.1: ***GAAP should be based on business activities,[20] rather than industries. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB be scoped on the basis of business activities rather than industries. Any new projects should include the elimination***

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[19] See discussion of bright lines below for further details.

[20] As discussed in section II.B of this chapter regarding management intent, we have not taken a position as to whether intent is an appropriate basis of accounting. Similarly, we express no view on whether intent provides a meaningful distinction between business activities.

of existing industry-specific guidance in relevant areas as a specific objective of those projects, unless, in rare circumstances, retaining industry guidance can be justified on the basis of cost-benefit considerations (discussed below).

The SEC should also recommend that, in conjunction with its current codification project, the FASB add a project to its agenda to remove or minimize existing industry-specific guidance that conflicts with generalized GAAP, taking into account the pace of convergence efforts.[21]

Background

Industry-specific guidance refers to: (1) exceptions to general accounting standards for certain industries, (2) industry-specific guidance created in the absence of a single underlying standard or principle, and (3) industry practices not specifically addressed or based in GAAP. Industries covered by this guidance include, but are not limited to, the insurance, utilities, oil and gas, mining, cable television, financial, real estate, casino, broadcasting, and film industries.[22]

Industry-specific guidance has developed for a number of reasons. These include multiple standards-setters issuing guidance without consistently coordinating their efforts, a desire to enhance uniformity throughout an industry, and efforts to customize accounting standards for allegedly "special" transactions or investor needs. In some cases, industries have developed their own practices in the absence of applicable authoritative literature.

Industry-specific guidance contributes to avoidable complexity by making financial reports less comparable.[23] This is evident across industries, when conflicting accounting models are used for similar or identical transactions. It may also be used as an improper

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[21] Some constituents understand "convergence" to mean that GAAP and IFRS (as published by the IASB) will eventually be harmonized, at which point no substantive differences will exist between the two bodies of accounting literature. Others understand it to mean a discrete transition from GAAP to IFRS at a specified date without respect to whether the two bodies of literature are substantially harmonized. The timing of these two approaches may differ, which would likely impact the prioritization of this proposal to eliminate existing U.S. industry-specific guidance on the FASB's agenda. In either case, we believe industry-specific guidance should be substantially eliminated prior to convergence – either as a component of the convergence plan, or by establishing a specified date after which the use of industry-specific guidance would be prohibited.

[22] Refer to appendix B for additional examples.

[23] As noted previously in the *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (July 2003):

> The proliferation of specialized industry standards creates two problems that can hinder standard setters' efforts to issue subsequent standards using a more objectives-oriented regime:
>
> - The existence of specialized industry practices may make it more difficult for standard setters to eliminate scope exceptions in subsequent standards (e.g., many standards contain exceptions for insurance arrangements subject to specialized industry accounting)
> - The specialized standards may create conflicting GAAP, which makes it more difficult for accounting professionals to determine the appropriate accounting.

analogy to achieve desired results or to require more conservative accounting treatments (e.g., by auditors).[24] In addition, the use of an industry to define an accounting treatment raises serious questions about which companies are within the scope of specific guidance. This issue is especially pronounced for diversified companies, which may be involved in a number of different industries.

Further, industry-specific guidance unnecessarily increases the volume of accounting literature. This, in turn, adds to the costs of implementing such literature and maintaining it (e.g., monitoring it for interaction with other new and existing standards and expanding the size and scope of technical resources and databases). Industry-specific guidance also increases the cost of training accountants and retaining industry experts, while compounding the complexity that investors experience in understanding the present variety of accounting and disclosure standards. Lastly, it hinders more widespread use of XBRL by increasing the number of data tags that need to be created, maintained, and properly used to deliver financial information.

On the other hand, industry-specific guidance may alleviate complexity by allowing industry reporting to better meet the specific investor needs in that industry and enhancing comparability across entities within an industry. Further, it may depict important differences in the economics of an industry, particularly where application of a generalized principle may not result in accounting that is faithful to a transaction's substance. We also note that historically, some industry-specific guidance has filled a need where GAAP is otherwise lacking, and simplified or reduced the amount of guidance a preparer in an industry would need to consider (even though it might increase complexity across industries generally). Finally, specialized guidance has been able to address prevalent industry issues quickly because it was written for a narrower audience than generalized GAAP.

Industry-specific guidance can be broken into three categories. First, some industry-specific guidance is explanatory in nature and consistent with generalized GAAP, such as portions of AICPA Accounting and Auditing Guides that assist preparers interpret and apply existing, generalized GAAP. Second, other industry-specific guidance is inconsistent with generalized GAAP. For example, SFAS No. 51, *Financial Reporting by Cable Television Companies*, requires that initial hookup revenue (a type of nonrefundable upfront fee) is recorded to the extent of direct selling costs incurred; the remainder is deferred and recorded in income over the estimated average period that subscribers are expected to remain connected to the system. However, generalized guidance indicates this practice is inappropriate unless it is specifically prescribed elsewhere (such as SFAS No. 51).[25] Therefore, similar activities like upfront fees for

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[24] For instance, some auditors may use concepts in revenue recognition from the software industry (Statement of Position (SoP) 97-2) as a basis for postponing the revenue recognition of companies in other industries without on-point literature. Opponents of this practice argue such revenue deferral is too conservative and does not adequately portray the extent to which a company may have satisfied its product or service obligations in a long-term or multiple-element contract.

[25] SAB Topic 13.

gym memberships are not afforded equal treatment. Third, still other industry-specific guidance was created in the absence of a general principle that applies across industries. For instance, while there is no comprehensive revenue recognition standard, SoP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, discusses revenue and cost recognition in areas such as the construction industry.

Discussion

We generally believe that industry-specific guidance should be eliminated to reduce avoidable complexity, particularly as generalized GAAP is developed. However, we acknowledge that industry-specific guidance has merit when cost-benefit considerations indicate that the enhanced information investors would receive under generalized GAAP is not justified by the direct costs to preparers and the indirect costs to investors to account for activities in that manner. In such cases, the SEC should encourage the FASB to work with the relevant industry participants to identify long-term ways to improve the benefits and mitigate the costs of the general standard. After making these changes, the related industry-specific guidance should be phased out as efficiently as possible. Towards that end, the SEC should encourage the FASB to provide sufficient time to allow companies to adopt generalized GAAP with minimal transition costs.

Similarly, we recognize that industry-specific guidance may be helpful in situations in which: (1) it interprets, rather than contradicts, principles, and (2) the activities in question are legitimately different, which are expected to be rare. But to the extent that such guidance interprets principles (i.e., relates to implementation), we generally believe it should not be considered authoritative GAAP.[26] Further, to the extent that it applies to activities that are legitimately different, such guidance should be scoped and applied on the basis of business activities, rather than industries.

In implementing this proposal, we note that the FASB's codification project can be used to sort existing industry-specific guidance into one of the three categories identified above (consistent with GAAP, inconsistent with GAAP, or there is no comparable GAAP). We believe efforts to reduce existing industry-specific guidance should focus primarily on cases in which it is inconsistent with generalized GAAP. Further, as the FASB develops new generalized guidance in areas like revenue recognition, it should eliminate industry-specific guidance to the maximum extent feasible. Similarly, the SEC should eliminate its industry-specific guidance in related areas, if any.

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[26] We are aware of constituents, such as the AICPA, that have historically issued industry-specific implementation guidance. We generally believe such guidance should not be considered authoritative. Rather, all authoritative guidance should continue to be issued by designated standards-setters, such as the FASB in the U.S., as discussed in chapter 2 of this progress report. If a designated standards-setter issues implementation guidance for activities that are prevalent in particular industries, we believe it should be applicable to all transactions of the type in question, regardless of the industry in which a company operates.

From an international perspective, we note that IFRS currently contains less industry-specific guidance than GAAP and that such guidance focuses more on the nature of the business activity (e.g., agriculture, insurance contracts, exploration and evaluation of mineral resources). Nonetheless, the SEC should encourage the IASB to be mindful of developed proposal 1.1 as it continues to develop a more comprehensive body of standards. The SEC might also encourage the IASB to limit future industry-specific guidance to activities whose economics are legitimately different from other business activities. Otherwise, we believe specialized accounting for only certain subsets of similar activities will create avoidable complexity.

We acknowledge that the elimination of existing industry-specific guidance may result in more complexity over the short-term to the industries losing special treatment. Nonetheless, we believe it is an acceptable cost for a long-term reduction in avoidable complexity.

II.B. Alternative Accounting Policies

Developed Proposal 1.2: ***GAAP should be based on a presumption that formally promulgated alternative accounting policies should not exist. The SEC should recommend that any new projects undertaken jointly or separately by the FASB not provide additional optionality, unless, in rare circumstances, it can be justified. Any new projects should include the elimination of existing alternative accounting policies in relevant areas as a specific objective of those projects, unless, in rare circumstances, the optionality can be justified.***

Background

Alternative accounting policies refer to optionality in GAAP. The following discussion addresses formally-promulgated options in GAAP, but does not address choices available to preparers at more of a practice or implementation level.[27] Examples of optionality in GAAP include:[28]

- The indirect versus the direct method of presenting operating cash flows on the statement of cash flows
- The application of hedge accounting[29]
- The option to measure certain financial assets and liabilities at fair value
- The immediate or delayed recognition of gains/losses associated with defined benefit pension and other post-retirement employee benefit plans

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[27] For example, companies are free to choose from among several depreciation methods – straight-line, double-declining balance, etc.

[28] Refer to appendix B for additional examples.

[29] We have noted complexities arising from the application of hedge accounting, which allows entities to mitigate reported volatility over the life of the hedge relationship. In this regard, we generally feel that instead of assessing hedge effectiveness to determine whether companies qualify for this alternative accounting treatment, a better policy would be to simply record the ineffective portion of a hedge in earnings (i.e., a proportionate approach versus an all-or-nothing approach). We are also aware of the FASB's derivatives project in this area and are generally supportive of its progress.

- The successful efforts or full cost accounting method followed by oil and gas producers.

Alternative accounting policies arise for a number of reasons. These reasons include circumstances in which the pros and cons of competing policies may be balanced and thus do not result in a single, clearly preferable approach. Other causes encompass political pressure that results in standards-setters providing for a preferred and an alternative accounting method, high administrative costs of the preferred alternative to preparers (e.g., cost-benefit considerations), and a portrayal of differences in management intent.

Alternative accounting policies contribute to avoidable complexity by making financial reports less comparable. This is evident across companies when identical activities are accounted for differently. Such alternatives may permit accounting that is less reflective of economic substance to the extent that they are based on political pressure, and facilitate differences in accounting policies selected by preparers to achieve the most favorable treatment. The unnecessary proliferation of accounting literature to codify these alternatives also adds to avoidable complexity.

On the other hand, alternative accounting policies may alleviate complexity by allowing preparers to determine the best accounting for particular entities based on cost and economic substance, to the extent that more than one accounting policy is conceptually sound. In addition, certain alternative policies may be developed more quickly than a final "perfect" standard to minimize the effect of other unacceptable practices. In other words, they may function as a short-term fix on the road to ideal accounting.

Management Intent

Some alternative accounting policies are based on management intent.[30] Management intent is a present assertion about management's plans for future courses of action.[31]

We have separately considered the merits of alternative accounting policies arising from differences in management intent. Opponents of the use of management intent as a basis for accounting believe that because intentions are subjective, it is difficult to use intent as a basis for accounting. Opponents also believe that intent does not change the economics of a transaction and thus, would not be a representationally faithful basis of accounting.

Proponents assert that the economics of a transaction do, in fact, change based on the nature of the activity, which is driven by management intent. Proponents also note that,

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[30] For example, SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities*, allows management to classify certain debt instruments as either a held-to-maturity, an available-for-sale, or a trading security based on the company's intent and ability with respect to the holding period of its investment. The financial statement treatment differs for all three categories.

[31] The definition of management intent and certain other concepts in the discussion of alternative accounting policies are adapted from a FASB *Special Report: Future Events: A Conceptual Study of Their Significance for Recognition and Measurement* (1994).

while management intent is subjective and could change, this characteristic is no different from a management estimate, which is common in financial reporting. Proponents further argue that financial reporting that ignores management intent results in irrelevant information for investors, for instance, reporting the fair value of a held-to-maturity security that will not be settled for 30 years.

Due to the varying levels of management intent throughout GAAP and the merits of the arguments both for and against its use, we have determined that accounting based on management intent is too dependent on facts and circumstances to feasibly address within our timeframe.

Discussion

Setting aside any consideration of management intent, we believe alternative accounting policies should be eliminated, except in limited circumstances in which they may have merit. Possible justifications for retaining alternative accounting policies include situations in which: (1) multiple accounting alternatives exist that are consistent with the conceptual framework, and none are determined to provide significantly better information to investors than others, and (2) an alternative or interim treatment can be developed more quickly than a final "perfect" standard to minimize the effect of other unacceptable practices.

If one or both of the justifications above apply, we believe that the provision of alternative accounting principles should be coupled with a long-term plan by the FASB to eliminate the alternative(s) through the use of sunset provisions and that the effect of applying the alternative policy not selected by preparers should be clearly and succinctly communicated to investors (e.g., through footnote disclosure).

Further, as new guidance is issued, including that which is issued through the convergence process, the SEC should eliminate its alternative accounting policies in related areas, if any.

From an international perspective, we note that IFRS currently permits numerous alternative accounting policies. While we acknowledge the IASB's efforts in reducing some of these alternative treatments, we nonetheless believe that the SEC should encourage the IASB, like the FASB, to be mindful of this proposal, and seek to eliminate alternatives as part of its standards-setting projects.

III. Bright Lines

Conceptual Approach 1.A: ***We are considering recommending expanded use of the following, in place of the current use of bright lines, to better reflect the economic substance of an activity:***

- ***Proportionate recognition – We use the term "proportionate recognition" in contrast to the current all-or-nothing recognition approach in GAAP. For***

example, consider a lease in which the lessee has the right to use a machine, valued at $100, for four years. Also assume that the machine has a 10-year useful life. Under proportionate recognition, a lessee would recognize an asset for its right to use the machine (rather than for a proportion of the asset) at approximately $40[32] on its balance sheet. Under the current accounting literature, the lessee would either recognize the machine at $100 or recognize nothing on its balance sheet, depending on the results of certain bright line tests.

- ***Additional disclosure – We recognize that proportionate recognition is not universally applicable. In those cases, enhanced disclosure may be more appropriate. We have yet to define the possible scope of proportionate recognition and/or enhanced disclosure, but it may extend to areas such as leases, consolidation policy and off-balance sheet activity.***

- ***Rules-of-thumb or presumptions, both coupled with additional considerations – We use rule-of-thumb and presumption to describe a method by which an accounting conclusion may be initially favored, subject to the consideration of additional factors. These are less stringent than bright lines, and may be appropriate where proportionate recognition may not apply.***

Conceptual Approach 1.B: Further, we are considering a recommendation related to the education of students, as well as to the continuing education of investors, preparers, and auditors. The recommendation would encourage understanding of the economic substance and business purposes of transactions, in contrast to mechanical compliance with rules without sufficient context.

Background

Bright lines refer to two main areas: quantified thresholds and pass/fail tests.[33]

Quantified thresholds include hard-and-fast cutoffs, as well as rules-of-thumb or presumptions – both coupled with additional considerations. Lease accounting is often cited as an example of bright lines in the form of quantified thresholds. Consider, for example, a lessee's accounting for a piece of machinery. Under current requirements, the lessee will account for the lease in one of two significantly different ways: either (1) reflect an asset and a liability on its balance sheet, as if it owns the leased asset, or (2) reflect nothing on its balance sheet. The accounting conclusion depends on the results of

[32] Calculated as (4 year lease / 10 year useful life) x $100 machine value. The example is only intended to be illustrative and is not prescriptive. For instance, the basis of proportionate recognition may be an asset's estimated useful life, future cash flows, or the share of a company's liabilities in a structured investment vehicle. We are planning additional deliberations in this regard.

[33] Refer to appendix B for additional examples other than those discussed in this section.

two quantitative tests,[34] where a mere 1% difference in the results of the quantitative tests leads to very different accounting.

With respect to rules-of-thumb, consolidation guidance[35] generally requires at least a 10% equity investment in a company (i.e., the equity investment expressed as a percentage of total assets) to demonstrate that the investee company is *not* considered a variable interest entity (VIE). The determination as to whether an entity is a VIE drives who, if anyone, ultimately consolidates the VIE in its financial statements. However, entities with investments above and below the 10% level can still be considered VIEs, depending on the particular facts and circumstances. That is, the 10% rule-of-thumb is not determinative in its own right.

Similarly, the business combination literature[36] contains an example of a presumption coupled with additional considerations. There are situations in which selling shareholders of a target company are hired as employees by the purchaser. For instance, the purchaser may wish to retain the sellers' business expertise. The payments to the selling shareholders may either be treated as: (1) part of the cost of the acquisition, which means the payments are allocated to certain accounts on the purchaser's balance sheet, such as goodwill, or (2) compensation to the newly-hired employees, which are recorded as an expense in the purchaser's income statement, reducing net income. Some of these payments may be contingent on the selling shareholders' continued employment with the purchaser, e.g., the individual must still be employed three years after the acquisition in order to maximize the total sales price. GAAP provides several factors to consider when deciding whether these payments should be treated as an expense or not, but establishes a presumption that any future payments linked to continued employment should be treated as an expense. It is possible this presumption may be overcome depending on the circumstances.

As indicated above, the other area of bright lines in this section includes pass/fail tests, which are similar to quantitative thresholds because they result in recognition on an all-or-nothing basis. However, these types of pass/fail tests do not involve quantification. For example, a software sales contract may require delivery of four elements. Revenue may, in certain circumstances, be recognized as each element is delivered. However, if

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[34] Specifically, SFAS No. 13, *Accounting for Leases*, requires that leases be classified as capital leases and recognized on the lessee's balance sheet where 1) the lease term is greater than or equal to 75% of the estimated economic life of the leased property or 2) the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of the fair value of the leased property, among other criteria.

[35] FASB Interpretation No. (FIN) 46 (revised December 2003), *Consolidation of Variable Interest Entities (FIN 46R).*

[36] Emerging Issues Task Force (EITF) 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*. We note EITF 95-8 is nullified by a new FASB standard, SFAS No. 141 (revised 2007), *Business Combinations*. SFAS No. 141 (revised 2007) states "A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation…" However, the guidance in EITF 95-8 is still helpful in describing our approach with respect to the use of presumptions coupled with additional considerations in GAAP.

appropriate evidence does not exist to support the allocation of the sales price to, for example, the second element, software revenue recognition guidance requires that the timing of recognition of *all* revenue be deferred until such evidence exists or all four elements are delivered.

Bright lines arise for a number of reasons. These reasons include a drive to enhance comparability across companies by making it more convenient for preparers, auditors, and regulators to reduce the amount of effort that would otherwise be required in applying judgment (i.e., debating potential accounting treatments and documenting an analysis to support the final judgment), and the belief that they reduce the chance of being second-guessed. Bright lines are also created in response to requests for additional guidance on exactly how to apply the underlying principle. These requests often arise from concern on the part of preparers and auditors of using judgment that may be second-guessed by inspectors, regulators, and the trial bar. Finally, bright lines reflect efforts to curb abuse by establishing precise rules to avoid problems that have occurred in the past.

Bright lines can contribute to avoidable complexity by making financial reports less comparable. This is evident in accounting that is not faithful to a transaction's substance, particularly when application of the all-or-nothing guidance described above is required. Bright lines produce less comparability because two similar transactions may be accounted for differently. For example, as described above, a mere 1% difference in the quantitative tests associated with lease accounting could result in very different accounting consequences. Some bright lines also permit structuring opportunities to achieve a specific financial reporting result (e.g., whole industries have been developed to create structures to work around the lease accounting rules). Further, bright lines increase the volume of accounting literature as standards-setters and regulators attempt to curb abusively structured transactions. The extra literature creates demand for additional expertise to account for certain transactions. All of these factors add to the total cost of accounting and the risk of restatement.

On the other hand, bright lines may alleviate complexity by reducing judgment and limiting aggressive accounting policies. They may also enhance perceived uniformity across companies, provide convenience as discussed above, and limit the application of new accounting guidance to a small group of companies, where no underlying standard exists. In these situations, the issuance of narrowly-scoped guidance may allow for issues to be addressed on a more timely basis. In other words, narrowly-scoped guidance and the bright lines that accompany them may function as a short-term fix on the road to ideal accounting.

Discussion

We are still in the process of debating when, if at all, bright lines are justified in accounting literature. We note that even if the FASB limits the issuance of bright lines, other parties might continue to create similar non-authoritative guidance. As such, recommendations to limit bright lines would require a cultural shift towards acceptance of more judgment. Accordingly, any recommendations in the context of bright lines will

incorporate our consideration of a professional judgment framework, as discussed in chapter 3, and our consideration of interpretive implementation guidance and a new design approach to accounting standards, as discussed in chapter 2.

IV. Mixed Attribute Model and the Appropriate Use of Fair Value

Conceptual Approach 1.C: ***Measurement framework – While we may not have time to fully address when fair value is the appropriate measurement attribute, we understand that the FASB's joint conceptual framework project includes a measurement phase. We intend to study this project further and are considering a recommendation for the SEC to endorse that, as part of this project, the FASB develop a decision framework to provide a systematic approach for consistently determining the most appropriate measurement attribute for similar activities or assets / liabilities based on consideration of the trade off between relevance and reliability, and the various constituents involved in the financial reporting process.***

Conceptual Approach 1.D: ***Judicious Use of Fair Value – Due to implementation complexities, as noted below, we are considering whether the SEC should request that the FASB be judicious about issuing new standards and interpretations that require the expanded use of fair value in areas where it is not already required, until completion of a measurement framework. Over the long-term, this framework would be used to determine measurement attributes systematically.[37] We will also consider whether improvements related to certain existing, particularly-complex, standards that incorporate fair value, such as SFAS Nos. 133[38] and 140,[39] are warranted in the near-term.***

Conceptual Approach 1.E: ***Groupings in Financial Statement Presentation – We believe that a more consistently aggregated presentation of financial statements would alleviate some of the confusion and concerns regarding the use of fair value. Such presentation should result in the grouping of amounts and line items by nature of activity and measurement attribute within and across financial statements. We believe such a grouping would be more understandable to investors, particularly as it would more clearly delineate the nature of changes in income (e.g., fair value volatility, changes in estimate, and business activity). This presentation might also help investors assess the degree to which management controls each source of income.***

As part of the financial statement presentation project, the FASB has tentatively decided to segregate the financial statements into business (further divided into

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[37] We recognize that the joint FASB/IASB conceptual framework project, including the measurement phase, is a significant undertaking that most likely will not be completed in the near-term. Consequently, we may explore whether a recommendation is warranted for a formal SEC study regarding when fair value is appropriate in financial reporting. The study's report could then be incorporated in future standards-setting activity.

[38] *Accounting for Derivatives and Hedging Activities.*

[39] *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

operating and investing) and financing activities. The FASB has also tentatively decided to require a reconciliation of the statement of cash flows to the statement of comprehensive income. This reconciliation would disaggregate changes in assets and liabilities based on cash, accruals, and changes in fair value, among others.

We intend to study this project further and consider whether it would address the our leanings in this area and sufficiently facilitate investors' understanding of fair value.

<u>Conceptual Approach 1.F:</u> Additional Disclosure – We have identified potential areas for additional disclosure to more effectively signal to investors the level of uncertainty associated with fair value measurements in financial statements.[40] Specifically, we note that in some cases, there is no "right" number in a probability distribution of figures, some of which may be more fairly representative of fair value than others. Potential areas to be considered for additional disclosure may include:

- ***The valuation model***
- ***Statistical confidence intervals associated with certain valuation models***
- ***Key assumptions, including projections***
- ***Sensitivity analyses depending on the selection of key assumptions***
- ***The entity's position versus that of the entire market.***

<u>Conceptual Approach 1.G:</u> Disclosure Framework – We seek to balance additional disclosure requirements, including, if any, those under conceptual approach 1.F, with: (1) the perception that amounts recognized in financial statements are generally subject to more precise calculations by preparers and higher degrees of scrutiny by investors compared to merely disclosing such amounts in the footnotes, and (2) concerns regarding disclosure redundancies. To minimize the effect of diminishing returns on potential new disclosure improvements identified during the course of our efforts and future standards-setting activity, we are considering recommending: (1) that the SEC request the FASB to develop a disclosure framework that integrates existing disclosure requirements into a cohesive whole (e.g., eliminate redundant disclosures and provide a single source of disclosure guidance across all accounting standards), (2) improvement to the piecemeal approach to establishing disclosures (i.e., standard-by-standard), and (3) that the SEC develop a process to regularly evaluate and, as appropriate, update its disclosure requirements as new FASB standards are issued.

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[40] We acknowledge uncertainty also exists in other measurement attributes, such as historic cost, which may warrant similar disclosure.

Background

As previously noted, the mixed attribute model is one in which the carrying amounts of some assets and liabilities are measured based on historical cost, others at lower of cost or market, and still others at fair value. This complexity is compounded by requirements to record some adjustments to carrying amounts in earnings and others in comprehensive income.

Examples of accounting standards that result in mixed attribute measurement include two FASB standards related to financial instruments. SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, permits the fair valuation of certain assets and liabilities. As a result, some assets and liabilities are measured at fair value, while others are measured at amortized cost or some other basis. SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, requires certain investments to be recognized at fair value and others at amortized cost.

In practice, the costs associated with (potentially uncertain) fair value estimates can be considerable. Some preparers' knowledge of valuation methodology is limited, requiring the use of valuation specialists. Auditors often require valuation specialists of their own to support the audit. Some view the need for these valuation specialists as a duplication of efforts, at the expense of the preparer. In addition, there are recurring concerns about second-guessing by auditors, regulators, and courts in light of the many judgments and imprecision involved with fair value estimates. Regardless of whether such estimates are prepared internally or by valuation specialists, the effort and elapsed time required to implement and maintain mark-to-model fair values is significant.

Nevertheless, some have advocated mandatory and comprehensive use of fair value as a solution to the complexities arising from the mixed attribute model. However, opponents argue that this would only shift the burden of avoidable complexity from investors to preparers and auditors, among others. Specifically, certain investors may find uniform fair value reporting simpler and more meaningful than the current mixed attribute model. But under a full fair value approach, some objectivity would be sacrificed because many amounts that would change to fair value are currently reported on a more verifiable basis, such as historic cost. These amounts would have to be estimated by preparers and certified by auditors, as discussed above. Such estimates are made even more subjective by the lack of a single set of generally accepted valuation standards and the use of inputs to valuation models that vary from one company to the next. Likewise, significant variance exists in the quality, skill, and reports of valuation specialists, which preparers have limited ability to assess. Finally, there is no mechanism to ensure the ongoing quality, training, and oversight of valuation specialists. As a result, some believe a wholesale transition to fair value would reduce the reliability of financial reports to an unacceptable degree.

Therefore, we assume that a complete move to fair value is most unlikely. Within this context, the partial use of fair value increases the volume of accounting literature. Said differently, when more than one measurement attribute is used, guidance is required for

each one. In addition, some entities may operate under the impression that investors: (1) are averse to market-driven volatility, and as a result, (2) incorporate unfavorable assumptions or discounts within their assessments of a company's financial performance. Consequently, entities have demanded exceptions from the use of fair value in financial reporting, resisted its use, and/or entered into transactions that they otherwise would not have undertaken to artificially limit earnings volatility. These actions have resulted in a build up in the volume of accounting literature. More generally, some believe that attempts by companies to smooth amounts that are not smooth in their underlying economics reduce the efficiency and the effectiveness of capital markets.

Information delivery is made more difficult by fair value. Investors may not understand the uncertainty associated with fair value measurements (i.e., that they are merely estimates and in many instances lack precision), including the quality of unrealized gains and losses in earnings that arise from changes in fair value. Some question whether the use of fair value may lead to counterintuitive results. For example, an entity that opts to fair value its debt may recognize a gain when its credit rating declines. Others question whether the use of fair value for held to maturity investments is meaningful. Finally, preparers may view disclosure of some of the inputs to the assumptions as sensitive and competitively harmful.

Despite these difficulties, the use of fair value may alleviate some aspects of avoidable complexity. Such information may provide investors with management's perspective, to the extent management makes decisions based on fair value, and it may improve the relevance of information in many cases, as historical cost is not meaningful for certain items.

Fair value may enhance consistency by reducing confusion related to measurement mismatches. For example, an entity may enter into a derivative instrument to hedge its exposure to changes in the fair value of debt attributable to changes in the benchmark interest rate. The derivative instrument is required to be recognized at fair value, but, assuming no application of hedge accounting or the fair value option, the debt would be measured at amortized cost, resulting in measurement mismatches. Fair value might also mitigate the need for detailed application guidance explaining which instruments must be recorded at fair value and help prevent some transaction structuring. Specifically, if fair value were consistently required for all similar activities, entities would not be able to structure a transaction to achieve a desired measurement attribute.

Fair value also eliminates issues surrounding management's intent. For example, entities are required to evaluate whether investments are impaired. Under certain impairment models, entities are currently required to assess whether they have the intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. As discussed in section II.B of this chapter, management intent is subjective and, thus, less auditable. However, use of fair value would generally make management intent irrelevant in assessing the value of an investment.

Discussion

We acknowledge the view that a complete transition to fair value would alleviate avoidable complexity resulting from the mixed attribute model. However, we also recognize that expanded use of fair value would increase avoidable complexity, as discussed above, unless numerous implementation questions related to relevance and reliability are addressed, which extend beyond the scope of our work.

In light of our limited duration, we recognize that we may not independently develop a comprehensive measurement framework, but we plan to provide input to the FASB's projects in this area (see conceptual approach 1.C on the measurement framework and conceptual approach 1.E on groupings in financial statement presentation). As a result, we believe that recommendations requiring a systematic measurement framework and better communication of measurement attributes would more feasibly reduce avoidable complexity resulting from the mixed attribute model. Such communication encompasses footnote disclosure of each measurement attribute's characteristics (e.g., uncertainty associated with fair value), as well as a more systematic presentation of distinct measurement attributes on the face of the primary financial statements.

V. Future Considerations

As noted in the introduction to this chapter, exceptions to general principles create complexity because they deviate from established standards that are applicable to most companies. Our developed proposals with respect to industry-specific guidance and alternative accounting policies address two forms of this diversity. We intend to deliberate two remaining forms of such diversity during the course of our work later in 2008.

Scope Exceptions in GAAP other than Industry-Specific Guidance[41]

As noted previously, scope exceptions other than industry-specific guidance represent departures from a principle. They contribute to avoidable complexity because they result in different accounting for similar activities, require detailed analyses to determine whether or not they apply in particular situations, and increase the volume of accounting literature. On the other hand, the value of scope exceptions will be considered in light of cost-benefit considerations, practical approaches to issuing guidance in the near-term before more principled standards can be developed, and the magnitude of change that would result from eliminating or reducing them.

Examples of scope exceptions include: (1) a contract that has the characteristics of a guarantee under FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others*, but is treated as contingent rent under SFAS No. 13, *Accounting for Leases*; (2) the business scope

[41] We have limited our focus to scope exceptions, while acknowledging there are other types of exceptions in GAAP. This limited approach was considered appropriate in light of our short duration.

exception to the applicability of FIN 46R, *Consolidation of Variable Interest Entities*, subject to certain criteria; and (3) the application of SFAS No. 157, *Fair Value Measurements*, to share-based payment transactions.

Competing Models

Competing models are distinguished here from alternative accounting policies. Alternative accounting policies, as explained above, refer to different accounting treatments that preparers are *allowed to choose* under existing GAAP (e.g., whether to apply the direct or indirect method of cash flows). By contrast, competing models refer to *requirements to apply* different accounting models to account for similar types of transactions or events, depending on the balance sheet or income statement items involved.

Examples of competing models include different methods of asset impairment testing such as inventory, goodwill, and deferred tax assets, etc.[42] Other examples include different methods of revenue recognition in the absence of a general principle, as well as the derecognition of most liabilities (i.e., removal from the balance sheet) on the basis of legal extinguishment compared to the derecognition of a pension or other post-retirement benefit obligation via settlement, curtailment, or negative plan amendment.

Competing models contribute to avoidable complexity in that they lead to inconsistent accounting for similar activities, and they contribute to the volume of accounting literature. On the other hand, the value of competing models will be considered in light of cost-benefit considerations, practical approaches to issuing guidance in the near-term before more principled standards can be developed, and the magnitude of change that would result from eliminating or reducing them. We will also explore the relationship between competing models and the FASB's conceptual framework.

[42] For instance, inventory is assessed for recoverability (i.e., potential loss of usefulness) and remeasured at the lower of cost or market value on a periodic basis. To the extent the value of inventory recorded on the balance sheet (i.e., its "cost") exceeds a current market value, a loss is recorded. In contrast, goodwill is tested for impairment annually, unless there are indications of loss before the next annual test. To determine the amount of any loss, the fair value of a "reporting unit" (as defined in GAAP) is compared to its carrying value on the balance sheet. If fair value is greater than carrying value, no impairment exists. If fair value is less, then companies are required to allocate the fair value to the assets and liabilities in the reporting unit, similar to a purchase price allocation in a business combination. Any fair value remaining after the allocation represents "implied" goodwill. The excess of actual goodwill compared to implied goodwill, if any, is recorded as a loss. Deferred tax assets are tested for realizability on the basis of future expectations. The amount of tax assets is reduced if, based on the weight of available evidence, it is more likely than not (i.e., greater than 50% probability) that some portion or all of the deferred tax asset will not be realized. Future realization of a deferred tax asset ultimately depends on the existence of sufficient taxable income of the appropriate character (e.g., ordinary income or capital gain) within the carryback and carryforward periods available under the tax law.

CHAPTER 2: STANDARDS-SETTING PROCESS

I. Introduction

A robust standards-setting process is the foundation of an efficient system of financial accounting and reporting, on which capital providers may rely to make investment decisions. Although the U.S. approach to financial reporting has been quite effective in achieving that overarching objective, GAAP has evolved over many years to a point whereby some of the basic principles are obfuscated by detailed interpretive rules, as well as various exceptions and alternatives, which reduce the usefulness of the resulting financial reporting. Historically, interpretative rules on how to implement GAAP (interpretive implementation guidance) have proliferated from a variety of sources and, intentionally or not, have become perceived as additional GAAP. This increases the complexity of the financial reporting system and reduces its transparency for investors, especially when questions exist about the authoritative nature of such guidance or conflicts exist between interpretations.

This chapter advances developed proposals, conceptual approaches, and matters for future consideration intended to alleviate some of these concerns. Specifically, after examining the U.S. standards-setting process, we propose changes in the following areas:

- Increased investor representation in standards-setting
- Enhancements in governance and oversight
- Improvements in the process of setting new standards
- Narrowing the sources of interpretive implementation guidance.

In general, we believe the design of the U.S. financial reporting system and the role played by each participant are appropriate. However, improvements to the existing standards-setting process, including the process of issuing interpretive implementation guidance, may significantly influence behaviors and thereby help financial reporting better serve the needs of investors.

Some of our proposals may be partially or substantially addressed by actions recently taken or in the process of being taken by the FAF, the FASB, and the SEC, which we reference where applicable. Other aspects of our proposals are already in place or occur informally in practice, but may not be fully effective or well understood. Nevertheless, our proposals are designed to increase the effectiveness and transparency of these processes.

II. Investor Representation

Investor representation in standards-setting is critical to maintaining an effective system of financial reporting, yet the intricacy of certain accounting matters has sometimes made it difficult to attract meaningful investor participation. Our proposals are intended to underscore the pre-eminence of investor perspectives in developing and administering a well-designed and effective system of financial reporting. The current standards-setting process attempts to balance the views of different stakeholders. However, the financial

reporting system would best be served by recognizing that the perspectives of investors should be pre-eminent when competing interests cannot be aligned, because all stakeholders benefit from a system that allocates capital more efficiently.

We acknowledge the FASB's significant recent efforts to increase investor participation in standards-setting. Specifically, the FASB leveraged a number of existing advisory groups and created additional advisory groups to increase investor involvement. Our proposal below is intended to provide the FASB with more focused, efficient, and timely feedback from investors, both large and small.

Developed Proposal 2.1: ***Additional investor representation on standards-setting bodies is central to improving financial reporting. Only if investor perspectives are properly considered by all parties will the output of the financial reporting process meet the needs of those for whom it is primarily intended to serve. Therefore, the perspectives of investors should have pre-eminence. To achieve that pre-eminence in standards-setting, the SEC should encourage the following improvements:***

- ***Add investors to the Financial Accounting Foundation (FAF) to give more weight to the views of different types of investors, both large and small***
- ***Give more representation on both the FASB and the FASB staff to experienced investors who regularly use financial statements to make investment decisions to ensure that standards-setting considers fully the usefulness of the resulting information.***

FAF: Our proposal complements the FAF's recently proposed governance reforms.[43] The FAF proposes to expand the sources of FAF Trustee nominations, change terms of service, and create flexibility in the size of the FAF itself. We support these proposals, particularly the decision to reduce reliance on constituent-based sponsoring organizations to put forward FAF Trustees. However, we believe additional investor representation on the FAF should also be emphasized. Such representation should strive to consider differing perspectives in the investing community.

FASB and FASB Staff: Increasing direct investor involvement on the Board would benefit the FASB by bringing investor perspectives to the forefront of standards-setting and the process of issuing interpretive implementation guidance. We propose that the composition of the Board include no fewer than one, and perhaps more than one, experienced investor who regularly uses third-party financial statements to make investment decisions.

Our proposal assumes that the FAF will implement its proposed reduction in the size of the FASB from seven to five members. If this reduction is made, we believe the composition of the Board should be reconsidered to require that a preparer, an auditor,

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[43] FAF, *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB* (December 18, 2007). Our deliberation of the FAF request for comments focused on the FAF and FASB proposals, as the Governmental Accounting Standards Board (GASB) is outside of our scope.

and at least one experienced investor who regularly uses third-party financial statements to make investment decisions are all represented. In our view, although academic representation on the Board should be actively sought, it should not be mandated. If the FASB consists of five members, our suggested approach would increase the influence of investors. While we recognize that workload capacity concerns may be created by a reduction in the size of the Board, we believe that these concerns may be mitigated by more delegation of responsibilities to senior staff members and a possible increase in the size of the FASB staff. On the other hand, if the FAF does not reduce the FASB's size, at least two investors should be required on the Board. The remaining at-large Board members should be selected from the most qualified individuals who possess a breadth of experiences that will ensure that the perspectives of investors are carefully considered.

There may be opportunities to increase investor representation on the FASB staff as well. The FASB has a few staff with professional investing experience. The FASB also has had a fellowship program for many years, but fellows usually come from the auditor and preparer communities. The FASB has approached investor groups about the possibility of sponsoring fellows, but, thus far, has had limited success. Investors should promote the fellowship positions and encourage qualified applicants to join the FASB staff to help enhance investor input in standards-setting.

In addition, the FAF should consider staffing alternatives that make greater use of part-time Board members or part-time senior staff for particular projects or purposes. However, we recognize that conflict of interest and independence issues would have to be resolved.

III. FAF and FASB Governance

The FAF Board of Trustees is responsible for the oversight, funding, and appointment of Board members of the FASB and the GASB. While the FAF Board of Trustees does not direct the standards-setting activities of the FASB, it does have a responsibility to periodically review the FASB's structure and governance to assess its effectiveness and efficiency. The FAF has always maintained oversight of the FASB as one of its main priorities. Our proposal below is designed to promote more active FAF oversight of the FASB – in order to shorten the time taken to develop standards, as well as to improve their quality:

Developed Proposal 2.2: ***The SEC should assist the FAF with enhancing its governance of the FASB, as follows:***

- ***By encouraging the FAF to develop performance metrics to assess the FASB's adherence to the goals in its mission statement, objectives, and precepts and to improve its efficiency***
- ***By supporting the FAF's changes outlined in its "Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB," with minor modifications regarding composition of the FAF and the FASB, as proposed in section II of this chapter, and agenda-setting, as proposed in section IV of this chapter***

- ***By encouraging the FAF to amend the FASB's mission statement, stated objectives, and precepts to emphasize that an additional goal should be to minimize avoidable complexity.***

Performance Metrics: The FAF should develop performance metrics to assess the FASB's adherence to the goals in its mission statement, objectives, and precepts. These metrics should track the timeliness and effectiveness of the FASB's standards-setting process. Such metrics would not have a detrimental impact on the FASB's independence. Rather, they would improve accountability in standards-setting.

Proposed FAF Governance Changes: We support the FAF's governance proposals as outlined below, with minor modifications regarding composition of the FAF and the FASB, as proposed in section II of this chapter, and agenda-setting, as proposed in section IV of this chapter:

FAF Oversight: The FAF proposes to increase its active oversight of the FASB. We support this proposal, but we note that the FAF has not described how it intends to implement it. Many of the developed proposals and conceptual approaches in this chapter provide input regarding how and in what areas to strengthen such oversight.

FASB Voting: The FAF proposal maintains the FASB's current simple majority voting requirement. We support simple majority rather than supermajority voting to promote the timeliness of standards-setting.

Mission and Objectives: The FASB's mission statement, objectives, and precepts acknowledge that efficient capital markets rely on credible, concise, and understandable financial information. They also recognize the importance of the following:

- Improving the usefulness of financial information by focusing on relevance, reliability, comparability, and consistency
- Keeping standards current
- Considering promptly significant areas of deficiency that need improvement
- Promoting international convergence
- Improving the understanding of the nature and purpose of information in financial reports
- Being objective in decision-making and promoting neutrality of information
- Weighing carefully the views of constituents
- Satisfying the cost-benefit constraint
- Minimizing disruption by providing reasonable effective dates and transition provisions
- Reviewing the effects of past decisions in a timely fashion to interpret, amend, or replace standards, when necessary
- Following an open, orderly process for standards-setting.

We believe minimizing avoidable complexity should be added to this list. Although we do not believe the FASB sets out to issue complex standards, amending the mission

statement, stated objectives, and precepts may promote more explicit consideration of less complex accounting alternatives during standards-setting.

IV. Standards-Setting Process Improvements

The U.S. standards-setting process requires significant due process. The FASB's activities are open to public participation and observation, and the FASB actively solicits the views of its various constituents on accounting issues. We believe the FASB's approach to obtaining significant input through its open due process is fitting, although there is a difficult trade-off between a transparent due process and expediency.

We believe the FASB's processes need improvement. Critics argue that it may take too long for the issuance of new accounting standards or interpretive implementation guidance in response to changes in business practices or the economic environment. They point to projects that have been on the FASB's agenda for years to illustrate that fundamental issues are routinely given low priorities. They further argue that new standards are not always consistent and may be based on several different, or even conflicting, principles. This may be due to a number of reasons, including the lack of a completed conceptual framework, competing priorities placed on the Board, or the evolutionary nature of standards-setting in the U.S.

Due to its practice of being continually open to constituent input, the FASB may receive conflicting advice regarding its agenda. Projects are frequently added to the agenda in response to requests from constituents, but projects not being actively considered are seldom removed. The FASB may be working on projects that could be better addressed in other ways, or not at all. In either case, such projects divert resources from other important agenda items. Further, even though the FASB has a transparent due process, new standards are often met with requests for interpretive implementation guidance, implementation deferral, or amendment.

Our proposal below is designed to further enhance the U.S. standards-setting process and its timeliness.

Developed Proposal 2.3: ***The SEC should encourage the FASB to further improve its standards-setting process and timeliness, as follows:***

- ***Create a formal Agenda Advisory Group that includes strong representation from investors, the SEC, the PCAOB, and other constituents, such as preparers or auditors, to make recommendations for actively managing U.S. standards-setting priorities***
- ***Refine procedures for issuing new standards by: (1) implementing investor pre-reviews designed to assess perceived benefits to investors, (2) enhancing cost-benefit analyses, and (3) requiring improved field visits and field tests***
- ***Improve review processes for new standards by conducting post-adoption reviews of every significant new standard, generally within one to two years of its effective date, to address interpretive questions and reduce the diversity of practice in applying the standard, if needed***

- ***Improve processes to keep existing standards current and to reflect changes in the business environment by conducting periodic assessments of existing standards.***

Some of our proposed process improvements call for formalizing or improving existing processes, or implementing new processes to improve standards-setting outputs. Our proposed Agenda Advisory Group would help the FASB, the SEC, and other participants in the financial reporting community focus efforts on the most meaningful activities and centralize constituent input to improve the timeliness of standards-setting.

Agenda Advisory Group: The first step in standards-setting is agenda-setting. The FASB receives many requests to act on various topics from many constituents, including the SEC. The FASB also needs to fulfill its obligations under the Memo of Understanding with the IASB regarding international convergence. Requests for interpretations or amendments divert attention from other critical agenda items. FASB agenda decisions often add rather than delete projects. Further, given the volume of activity on the FASB agenda, Board and staff prioritization conclusions are not always clear to constituents. What may result is that projects being addressed may not be responsive to widely acknowledged needs, or projects may not have sufficiently-defined scopes to address these needs in a timely fashion. The FASB has a number of existing advisory groups and committees that it consults about issues that may affect its agenda and project priorities; however, we believe there needs to be increased accountability to the FAF on agenda-setting and project priorities.

An Agenda Advisory Group that includes strong representation from investors, the SEC, the FASB, and the PCAOB, as well as other interested parties such as preparers and auditors, should be created to provide advice on agenda-setting. By identifying emerging issues and building consensus about which group is best positioned to deal with them (e.g., the FASB, the EITF, or the SEC) and in what form, the Agenda Advisory Group would give immediate input about how best to prioritize near-term versus long-term priorities. The main goals of such a group would be to:

- Help standards-setting become more nimble
- Assist the FASB is setting an achievable, strategic agenda, rather than one that includes projects proposed for many years with little progress
- Recommend when it is appropriate for the SEC or other parties to issue interpretive implementation guidance related to emerging issues and issues observed by the SEC in its registrant reviews
- Help the FASB maintain the usefulness of its authoritative guidance by recommending areas that need to be kept current
- Shield the FASB from influence by any single group of constituents, thereby protecting its independence
- Inject accountability into agenda-setting for all involved parties.

Our proposal complements the FAF's proposed changes to the FASB's agenda-setting process in which the FAF would give the FASB Chairman control over the FASB's agenda. We believe instilling more decision-making authority in the FASB Chairman,

combined with a requirement to consult with the proposed Agenda Advisory Group, would be a positive step toward increasing the FASB's efficiency.

In creating such an Agenda Advisory Group, the SEC and the FASB should consider ways to implement the following objectives:

- Timeliness. The Agenda Advisory Group should be convened both on a regular schedule and on short notice telephonically to deal with urgent matters, as necessary.
- Accountability. The Agenda Advisory Group should vote on certain aspects of the standards-setting agenda and provide that information in an advisory capacity to the FASB Chairman, who would then make the final agenda decision. Part of the rationale for calling a vote would be to increase accountability of the FASB Chairman to the FAF regarding agenda-setting effectiveness.
- Active involvement of key groups of investors. Key investor groups should be actively involved in agenda-setting to maintain an appropriate focus on investor needs.
- Involvement of the SEC. Due to the SEC's oversight responsibility for standards-setting, one or more senior representatives from the SEC Office of the Chief Accountant (OCA) should be on the Agenda Advisory Group, as the SEC typically identifies practice issues before the FASB does. In addition, active involvement by the SEC will allow coordination of how and by whom guidance should be issued, thereby reducing the impetus for the SEC to issue interpretive implementation guidance separately from the codified version of GAAP (see section VI of this chapter).
- Involvement of the FASB. All Board members should be invited as official observers.
- Involvement of the PCAOB. A senior representative from the PCAOB should be invited as an official observer, as actions taken by the PCAOB significantly impact behavior of participants in the U.S. financial reporting community.
- Involvement of others. Constituents otherwise not represented should be able to submit agenda requests and track agenda decisions, similar to the way in which the EITF functions.

Formulating and Proposing New Standards: The FASB has an elaborate process for formulating and proposing new standards. This process is designed to ensure that proposed standards properly address significant issues, are consistent with business practices and economics, and have benefits that justify accounting changes. It involves staff preparation of a draft proposal, publication of the proposal with an opportunity for public comment, and approval of the final standard. Throughout the process, the FASB consults with and receives input from a diverse group of constituents. This process is time consuming, often taking many years, and could be made more efficient. The Board's outreach to certain constituents sometimes seeks advice only on detailed issues rather than the scope of projects and broad matters. Our proposal would increase the efficiency and effectiveness of standards-setting by obtaining more focused inputs at an earlier stage through investor pre-reviews, enhanced cost-benefit analyses, and more field visits and field testing.

Investor Pre-reviews: Although the FASB regularly consults with a number of standing investor advisory groups, we believe that there may be opportunities to both increase and more effectively manage investor involvement, so that interested parties know when and how to engage the FASB and its staff to assist in standards-setting. Specifically, the FASB should implement a scalable investor pre-review to assess perceived investor benefits prior to exposing new standards for public comment. The FASB should consider the following attributes when designing such a pre-review:

- Seek detailed comments from a diverse panel of investors (e.g., buy-side analysts, sell-side analysts, and rating agencies), all of whom should have strong interests in the outcome.
- Ask investors to consider the accounting guidance through the eyes of a serious retail investor to determine whether the new information provided would be decision-useful (whether it will provide better information than what is currently available). This should entail an evaluation of the costs and benefits of updating data analysis models with the new or improved information, as necessary.
- Revisit or even discontinue standards-setting projects based on the feedback received.

Cost-Benefit Analyses: The FASB evaluates whether the benefits of a proposed standard justify its costs prior to exposing it for public comment. However, participants in standards-setting have long acknowledged that reliable, quantitative cost-benefit calculations are seldom feasible, in large part because of the lack of available information on the costs and the difficulty in quantifying the benefits. Further, the magnitude of the benefits and costs is difficult to assess prior to actual implementation of the standard. As a result, cost-benefit considerations are often based on anecdotal evidence and do not always include useful input from preparers, auditors, investors, and regulators. Cost-benefit analyses should be a more rigorous, essential part of standards-setting and should be given more weight than they are today.

The FASB is currently considering new initiatives to improve its cost-benefit analyses. We support these efforts and, to complement them, the FASB should consider the following enhancements to its cost-benefit procedures:

- Select preparers, auditors, investors, and regulators to be involved based on their interest in the standard or interpretive implementation guidance being developed. Such participants should be involved in the process of assessing costs and benefits, as well as performing field visits and field testing, to the extent feasible.
- Expose the entire cost-benefit analysis for public comment (rather than a summary or abstract), thereby enhancing the ability of interested constituents to comment on the conclusions reached and the basis for these conclusions.
- Attempt to better quantify the costs (in addition to providing qualitative assessments). If there is concern about the accuracy or reliability of the data, frame these concerns in the analysis rather than omitting the data. The FASB should request a cost estimate and underlying methodology from constituents who claim that costs are excessive.
- Use information collected in the investor pre-review to supplement the assessment of the benefits.

- Refrain from discussing costs and benefits on a net basis, as this sometimes creates opacity around the data underlying such conclusions. The analyses of costs and benefits should be prepared separately, with an indication of how the Board weighed the evidence in its conclusion.
- Add auxiliary information to put the accounting standard or interpretive implementation guidance in context (e.g., include an expectation of the number of companies to be impacted by the standard, their overall market capitalization, or other metrics).
- Improve the documentation of the cost-benefit conclusions in new standards so that they may be referred to over time.
- Consider hiring an economist to assist in preparing and reviewing cost-benefit analyses.

Field Visits and Field Testing: Throughout the deliberation process, the FASB meets with a number of interested constituents regarding proposed standards (referred to as "field visits"). Once the proposed standard is exposed for public comment, the FASB at its discretion may conduct field tests, in which the implementation of a proposed standard is beta tested so that issues may be identified and resolved prior to final issuance of the new standard. However, as a practical matter, and because of resource constraints, robust field testing has not been part of the process for setting many recent standards. As a result, new standards are often met with requests for interpretive implementation guidance, implementation deferral, or amendment.

Whenever possible, scalable field visits and field tests should be a required part of standards-setting for all significant new standards to identify and resolve as many conceptual and implementation issues as practicable prior to issuance. These procedures may also identify less costly alternative accounting treatments. The rigor required for these procedures should be scaled based on the difficulty and length of time required to implement and the magnitude of the impact of the standard or interpretive implementation guidance. In addition, whenever possible, field visits and field testing should occur contemporaneously, to improve the focus and efficiency of receiving constituent input. Although robust field testing and field visits require resources and time, combining these efforts will make efficient use of the Board's and its staff's time. Moreover, by researching implementation questions prior to issuing a new standard, the FASB would reduce the amount of time spent considering possible interpretive implementation guidance, implementation deferral, or amendment.

The FASB also should leverage work already being done by preparers, auditors, and investors to assess the costs, benefits, operationality, and auditability of proposed standards. Requesting assistance from preparers, auditors, and investors, either directly or through task forces and resource groups (perhaps on more of a rotational basis than is done in practice today), would bring additional subject matter expertise and recent business experience to each field visit and field test.

Post-Adoption Reviews of New Standards: We acknowledge that it is difficult to identify and address all possible implementation issues in a new standard prior to it being issued

and adopted. Issues and questions are often identified during the initial implementation phase as preparers and auditors begin to apply a new standard in practice. Preparers, auditors, and others often monitor and take measures to reduce diversity in practice when implementing new standards by conferring amongst themselves and issuing non-authoritative interpretive implementation guidance. During this initial period, requests are often made of the FASB and the SEC to provide interpretive implementation guidance for new standards.

In the current financial reporting environment, preparers and auditors are sometimes viewed as being penalized for implementing their understanding of new accounting standards immediately after adoption. This is because any ambiguity or substantial gaps identified in the implementation period may lead the regulators to issue interpretive implementation guidance that differs from conclusions originally reached by the preparers and auditors.

The FASB should improve existing processes to consistently ensure timely consideration of implementation issues for new accounting standards. The goal of post-adoption reviews of new standards would be to determine if the new standard is accomplishing its intended purpose or whether it has unintended consequences that need to be resolved. The FASB currently does address questions that arise after new standards are issued – it regularly receives input from various constituents and periodically revisits some standards. However, the process of completing post-adoption reviews should be formalized in policy, be more systematic, involve input from a broader range of constituents, and be monitored using relevant performance metrics.

Specifically, the FASB should perform a post-adoption review for every significant new standard. The review should be completed no more than one to two years after the effective date of the standard, with completion sooner if the scale of the new standard is narrow or a large number of implementation questions arise. At the end of the review period, the FASB should reach a formal conclusion on each new standard to determine if interpretive implementation guidance would serve the needs of investors by reducing diversity in practice or otherwise improving the application of the standard (e.g., by resolving ambiguities in the wording or filling-in unintended gaps in the standard).

We believe that, when necessary, interpretive implementation guidance for new standards is best given by the FASB using:

- A transparent due process with public comment
- Appropriate transition guidance and required disclosures that will provide investors with useful information regarding possible changes in accounting
- The codified version of GAAP.

Understandably, some interpretive implementation guidance may be of such an urgent nature that a transparent due process would not be responsive to the needs of market participants. Therefore, we envision that the SEC or other parties, through representation on the Agenda Advisory Group, could assist by agreeing to issue interpretive implementation guidance in such situations (see section VI of this chapter).

Under our proposal, it is not contemplated that preparers would have the flexibility to implement new standards at different times nor have the ability to adopt early or late. Following the recent policy decision by the FASB precluding early adoption of new standards, our proposal contemplates transition guidance for a new standard with a stated, required implementation date. Similarly, this proposal is not a safe harbor. Violations of GAAP will continue to be dealt with by the SEC through the review, comment, restatement, and enforcement processes. However, the SEC should give appropriate consideration to situations in which there were ambiguities or gaps in the new standards that could be subject to more than one reasonable interpretation. For example, it may be inappropriate for the SEC to bring an SEC enforcement proceeding based on a new accounting standard if, after careful analysis and due diligence made in good faith, the registrant took a reasonable and supportable view of that standard, which was subsequently changed by formal amendment or published interpretation.

Periodic Assessment of Existing Standards: After a new accounting standard has been in place for a reasonable period, more data is likely to be available to evaluate its benefits and costs. Further, over time economic conditions and business practices may change, such that older accounting standards may lose their relevance and effectiveness. Some participants in the financial reporting community have commented that numerous accounting standards or models need immediate reevaluation. In today's economic environment, the accounting for securitizations and structured products with off-balance sheet risk are cited as needing reevaluation.[44] The accounting for financial guarantees, convertible debt, and derivatives and hedging activities are also frequently cited areas for improvement.

The process by which the FASB receives, evaluates, and addresses concerns about the usefulness of standards in a timely fashion is critical to the proper functioning of the U.S. capital markets. The FASB should improve and formalize this process to ensure that standards continue to be useful in the current economic and business environment. This should be done by formalizing the process of periodically requesting feedback from investors, preparers, auditors, and regulators regarding what areas of GAAP need reevaluation because they create practice problems or are unnecessarily complex. In addition, to identify other specific areas of GAAP in need of review, the FASB should consider the following:

- Restatement activity
- Emerging issues and the amount of interpretive implementation guidance issued on particular standards
- Changes in business practices and the economy
- New cost-benefit information as it becomes available.

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[44] SEC Staff, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (June 2005).

Further, when evaluating the feedback received from constituents and the results of its own research, the FASB should seek advice from the Agenda Advisory Group to help prioritize its agenda.

V. Interpretive Implementation Guidance

We believe that there are too many sources of interpretive implementation guidance. Historically, this guidance proliferated from a variety of sources, which intentionally or not, has been viewed as additional GAAP. In other words, interpretive implementation guidance that is not formally authoritative often is erroneously perceived by participants in the financial reporting and legal communities to be quasi-authoritative. The key risks associated with a proliferation of interpretive implementation guidance are that: (1) the appropriate rule may not be identified and considered, and (2) it may conflict with authoritative guidance, as well as with other non-authoritative guidance, causing uncertainty in application and legal risk.

Over the past few years, the FASB and the SEC have taken steps intended to reduce the proliferation of interpretive implementation guidance from different authoritative bodies. For example, the SEC recognized the standards of the FASB as *generally-accepted*, and the FASB limited the ability of other bodies to create authoritative guidance without FASB ratification. Nevertheless, the SEC staff continues to be a source of interpretive implementation guidance in its own right, through such vehicles as comment letters, staff speeches, SABs, and other forms of exchange that, although typically non-authoritative, are perceived as quasi-authoritative. Similarly, actions taken by the FASB and the SEC have not sufficiently curbed the creation of other non-authoritative interpretive implementation guidance, such as that from audit firms, preparer and industry groups, academia, the Center for Audit Quality (CAQ), and other regulators.

Our proposal below, which should be read in conjunction with conceptual approach 2.A, is designed to recognize recent accomplishments in this area, clarify what guidance is authoritative and non-authoritative, and further influence the behaviors that have led to the desire for more guidance:

Developed Proposal 2.4: ***The number of parties that either formally or informally interprets GAAP and the volume of interpretative implementation guidance should continue to be reduced. The SEC should coordinate with the FASB to clarify roles and responsibilities regarding the issuance of interpretive implementation guidance, as follows:***

- ***The FASB Codification, a draft of which was released for verification on January 16, 2008, should be completed in a timely manner. In order to fully realize the benefits of the FASB's codification efforts, the SEC should ensure that the literature it deems to be authoritative is integrated into the FASB Codification to the extent possible, or separately re-codified, as necessary.***
- ***To the extent practical, going forward, there should be a single standards-setter for all authoritative accounting standards and interpretive implementation guidance that are applicable to a particular set of accounting standards, such as***

GAAP or IFRS. For GAAP, the FASB should continue to serve this function. To that end, the SEC should only issue broadly applicable interpretive implementation guidance in limited situations (see section VI).

- ***All other sources of interpretive implementation guidance should be considered non-authoritative and should not be required to be given more credence than any other non-authoritative sources that are evaluated using well-reasoned, documented professional judgments made in good faith.***

FASB Codification: The FASB has undertaken a significant project to develop a comprehensive, integrated Codification of existing accounting literature organized by subject matter that is intended to become an easily retrievable single source of GAAP. To that end, on January 16, 2008, the FASB released a draft of the FASB Codification that will be subject to a one-year verification period. We applaud the FASB's foresight on such a project and recognize the significant effort the project has entailed. The FASB Codification:

- Brings together all GAAP from all authoritative sources except the SEC and classifies it by topic into a single, searchable database so that it may be more easily researched
- Clarifies what guidance is authoritative versus non-authoritative
- Puts accounting standards into a consistent format, to the extent possible.

Although the FASB Codification does not change the substance of GAAP, it should make its application easier. However, SEC literature, which has developed through different mechanisms, is not as easily integrated into the FASB Codification.[45] Similarly, the FASB Codification does not deal with either the root causes of the proliferation of interpretive implementation guidance or the behavior of participants in the U.S. financial reporting community that caused the complexity. Notwithstanding these concerns, we support the FASB's efforts to verify the Codification. To further improve the Codification, the SEC should re-codify its guidance using a consistent format, and the FASB and the SEC should consider a second phase of the codification project that would systematically revisit GAAP, as discussed in section VI of this chapter.

Non-Authoritative Guidance: Although the FASB Codification will help clarify the roles of authoritative and non-authoritative guidance, meaningful improvements in financial reporting will be difficult if non-authoritative interpretive implementation guidance continues to be perceived, as it is today, as having quasi-authority in the marketplace. Our proposal is intended to foster acceptance of reasonable professional judgments made in good faith when they are supportable under GAAP. Specifically, non-authoritative interpretive implementation guidance should not be used to force restatements when other reasonable views exist that are supportable under GAAP.

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[45] Two of the benefits of the FASB Codification are its search feature and decimal system, which consistently organizes topics and subtopics within GAAP. No SEC guidance is currently included in the FASB Codification. To improve its usability in the future, the Codification will include authoritative content issued by the SEC, as well as selected SEC staff interpretations. However, the inclusion of SEC guidance will be for administrative convenience and will not supersede such guidance in its current form. Further, the SEC guidance will not follow the same organizational structure as the rest of GAAP.

We recognize there is often a need for interpretive implementation guidance and that such guidance can serve an important purpose. The volume of interpretative implementation guidance should be reduced, and it should be clearly identified as non-authoritative.

VI. Conceptual Approaches and Future Considerations

As discussed more fully below, we are considering a number of conceptual approaches and matters for future consideration to improve standards-setting:

Conceptual Approach 2.A: ***To further reduce interpretive implementation guidance associated with GAAP, we are considering proposing that the SEC further clarify its role vis-à-vis the FASB, as well as its internal roles and responsibilities, to mitigate the risk of its actions unintentionally driving behavior by market participants, as follows:***

- ***The SEC should clarify that registrant-specific matters are not authoritative forms of interpretive implementation guidance under GAAP and, accordingly, registrants other than the specific registrant in question are not required to take into account such registrant-specific matters.***
- ***The SEC staff should refrain from informally communicating broadly applicable interpretive implementation guidance (e.g., staff speeches) that are likely to be perceived as changing the application of GAAP. Rather, such communications should be used to highlight authoritative interpretive implementation guidance that has already been issued.***
- ***In instances in which the SEC staff identifies registrant-specific accounting matters that it believes may result in the need for broader interpretive implementation guidance or a clarification of an accounting standard under GAAP, the SEC staff should refer these items to the FASB as part of the Agenda Advisory Group.***
- ***When it is necessary for the SEC or its staff to issue broadly applicable interpretive implementation guidance, it should try to provide such guidance: (1) in a clear communication identified as authoritative, (2) so that it can easily and immediately be integrated into a codification of SEC literature (as proposed in section V of this chapter), and (3) when expected to significantly change the application of GAAP, only after transparent due process and public comment to the extent practicable.***
- ***The SEC staff should revisit internal procedures and take further steps necessary to improve the consistency of its views on the application of GAAP.***

The SEC sometimes issues rules and interpretations that comprise part of authoritative GAAP. The SEC's rule-making activities are generally open to public participation and observation. However, other activities of the SEC and its staff do not occur with the same level of transparent due process and public comment. As discussed below, registrant-specific guidance is published in the form of comment letters, but appropriately does not need to be proposed in advance or subject to public comment. On the other

hand, to the extent the SEC promulgates interpretive implementation guidance that is broadly applicable and is expected to significantly change the application of GAAP, we are considering whether it should do so only after public notice and comment, whenever practicable.

Registrant-Specific Guidance: The SEC Division of Corporation Finance (Corp Fin) reviews and comments on financial reports filed by registrants that are not investment companies. Corp Fin has a process for facilitating the public availability of comment letters and registrant responses to these comment letters on the SEC's website upon completion of the review process. Corp Fin also receives letters from specific registrants requesting concurrence on various reporting and disclosure issues. Similarly, OCA and Corp Fin receive requests from specific registrants for concurrence on specific interpretative implementation issues. These letters are commonly referred to in the marketplace as "pre-clearance" letters.

Preparers and auditors may misconstrue registrant-specific accounting outcomes as quasi-authoritative. However, registrant-specific matters are appropriately not subject to the same public deliberation and comment as SEC rule-making, because they are registrant-specific and are not intended to be applied more broadly. Nevertheless, preparers and auditors may overreact by applying these outcomes to similar, yet different, transactions, sometimes believing that restatement is required.

We are deliberating whether the SEC should make clear that comments provided to a specific registrant are not binding on other registrants. Clarifying that such comments are non-authoritative would help:

- Prevent preparers and auditors from giving undue significance to SEC staff comments made to individual registrants
- Reduce the need for other parties to issue interpretive implementation guidance
- Support our proposal to refer broadly applicable accounting matters that require interpretive implementation guidance to the FASB.

Broadly Applicable Guidance: To inform the public about broadly applicable interpretive implementation guidance, the SEC uses various forms of communication, including SABs,[46] letters to industry, staff speeches, public announcements, and training manuals. In addition, Corp Fin publishes and maintains interpretive implementation guidance on the SEC's website. While all of these publications contain disclaimers as to their non-authoritative nature, many participants in the financial reporting community

[46] The SEC authorized the use of SABs in 1975 to achieve a wider dissemination of the administrative interpretations and practices utilized by the SEC staff in reviewing financial statements. There had been concern that smaller audit firms and issuers would be disadvantaged because there had previously been no formal dissemination of staff practices. SABs were also designed to provide a means by which new or revised interpretations and practices could be quickly and easily communicated to registrants and their advisors. As they are designed to disseminate staff administration practices on a timely basis to the broader public, SABs are generally not exposed for public comment before release.

consider these disclaimers to be boilerplate and regard such interpretive implementation guidance as quasi-authoritative.

These publications are typically viewed by the SEC staff as confirmations of existing accounting standards, rather than as supplemental interpretive implementation guidance. However, many of these publications have and continue to influence market behavior because they sometimes include SEC staff views that do, in fact, supplement existing GAAP. The SEC staff sometimes refers registrants to these publications to support their views on registrant-specific matters. As such, many argue that these documents exemplify the SEC staff effectively setting standards without transparent due process and public comment and point to restatements sometimes following the release of these documents as evidence of their quasi-authoritative nature in practice.

In addition, other individual sources of non-authoritative implementation guidance (e.g., audit firms and the CAQ) often publish their own guidance to broadly communicate what they perceive to be SEC staff's views and to drive consistency in practice. However, as discussed below, if the SEC were to increase its formal referral of broadly applicable interpretive matters to the FASB, which could issue guidance in an authoritative, timely fashion, the overall volume of interpretive implementation guidance would be reduced, as would conflicts between interpretations from different sources. We believe this would further influence behaviors that have led to the desire for more guidance.

We recognize that the SEC staff publishes guidance to address issues other than the application of GAAP. This conceptual approach is not directed towards such publications. We also recognize that the SEC staff, based on its review of thousands of filings each year, is in a unique position to publish its comment letters. Such publications are intended to reduce comments that each registrant receives in the review process by promoting a high degree of compliance with GAAP. We continue to consider what proposals to make in this area, but believe that the SEC staff should be diligent when preparing this information not to present comments in a manner that is likely to be perceived as interpretative implementation guidance.

Referral of Issues to the FASB: As discussed in section IV of this chapter, there were a number of standards that were communicated to the FASB that were in need of improvement that have yet to be improved. The SEC should formalize the mechanism by which it refers issues to the FASB, and one of the goals of SEC representation on the proposed Agenda Advisory Group would be to strengthen such a referral mechanism. This will permit the FASB to address the need for authoritative interpretive implementation guidance that is broadly applicable in a codified form, thereby reducing the need for the SEC to do so. It will also give the SEC greater insight into when the FASB and the EITF do not intend to issue interpretive implementation guidance, which will allow the SEC to be more responsive by issuing guidance, in the limited circumstances when necessary.

Consistency: We are considering whether there is a need for more coordination between the various offices and divisions within the SEC to improve the consistency of

accounting advice given by the SEC staff. Although there are processes in place to build consensus on accounting matters within the SEC, there may be room for improvement. The possibility of inconsistent accounting advice emanating from the SEC staff creates confusion in the marketplace.

Two processes exist (one in Corp Fin and one in OCA) for registrants to request reconsideration of conclusions expressed in either comment letters or in pre-clearance letters when registrants disagree with staff guidance or believe they are receiving inconsistent advice compared to other registrants. However, registrants may not always use these processes for a number of reasons, such as: (1) to avoid additional delays and missed market opportunities, (2) to avoid the risk of opening other accounting conclusions to reconsideration, and (3) fear of possible retribution (misguided or not). Therefore, although the SEC staff has created checks-and-balances in the form of reconsideration processes, they may not be utilized as anticipated.

We do not intend to limit the ability of the SEC staff to carry out its regulatory responsibilities in a timely fashion. That is why we have not yet proposed a specific course of action. We understand the SEC staff is reviewing its procedures in many of these areas and expects to unveil a number of changes in the coming months, including new procedures to enhance the consistency of registrant-specific accounting interpretations during filing reviews and increasing the understanding and usefulness of its reconsideration processes. We support these efforts and plan to review progress with the SEC staff in the coming months as we continue our deliberations.

Conceptual Approach 2.B: ***We are considering proposing that the SEC continue to encourage improvement in the way standards are written, as follows:***

- ***By supporting the writing of accounting standards according to an agreed-upon framework of what constitutes an optimal standard. Such standards should not strive to answer every question and close every loophole, but should be written with more clearly stated objectives and principles that may be applied to broad categories of transactions.***
- ***By supporting the writing of accounting standards in a manner that promotes trust and confidence in efficient markets by encouraging the use of professional judgments made in good faith. Specifically, preparers and auditors should apply the standards faithfully, and regulators should monitor and address abusive application of the standards.***

Optimal Design of Standards: Some participants in the U.S. financial reporting community believe that certain accounting standards do not clearly articulate the objectives and principles upon which they are based, because they are sometimes obscured by detailed rules, examples, scope exceptions, safe harbors, cliffs, thresholds, and bright lines. In addition, GAAP is often not written in plain English. This can create uncertainty in the application of GAAP, as rules cannot cover all possibilities and the underlying principles and objectives may not be clear.

Another significant concern about the current system of accounting standards is that the proliferation of accounting rules fosters accounting-motivated structured transactions. As discussed further in chapter 1, standards that have scope exceptions, safe harbors, cliffs, thresholds, and bright lines are vulnerable to manipulation by those seeking to avoid accounting for the substance of transactions using structured transactions that are designed to achieve a particular accounting result. This ultimately hurts investors, because it reduces comparability and the usefulness of the resulting financial information. Therefore, a move toward more objectives-oriented (or principles-based) standards may ultimately improve the quality of the financial reporting upon which investors rely.

The question of how to design standards going forward is at the center of a decade-long principles-based versus rules-based accounting standards debate. There has been much discussion in the marketplace on this topic, and there are differing views. The SEC has been a frequent participant in the debate and has long been supportive of principles-based (or objectives-oriented) standards.[47] The question of how standards should be designed going forward is a critical aspect of the standards-setting process.

Rather than engaging in a debate over terms such as "principles-based," "objectives-oriented," or "rules-based," we prefer to think of the design of accounting standards in terms of the characteristics they should possess. We are considering various suggestions for the optimal design of standards, including the work of the CEOs of the World's Six Largest Audit Networks. These CEOs are attempting to build consensus in the financial reporting community about what optimal accounting standards should look like in the future and whether a framework could be created that the standards-setters may refer to over time to ensure that these characteristics are optimized.

Their proposed framework was presented at the Global Public Policy Symposium in January 2008, which recommends that optimal accounting standards have the following characteristics:

- Faithful presentation of economic reality
- Responsive to investors' needs for clarity and transparency
- Consistency with a clear conceptual framework
- Based on an appropriately-defined scope that addresses a broad area of accounting
- Written in clear, concise, and plain language
- Allows for the use of reasonable judgment.[48]

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[47] For example, the SEC issued *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter* (April 2003), which included numerous recommendations for the FAF and FASB to consider, including greater use of principles-based accounting standards whenever reasonable to do so. The SEC staff also issued *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (July 2003), which further lauded the benefits of objectives-oriented standards.

[48] In his testimony before the U.S. Senate *Subcommittee in Securities, Insurance and Investment* (October 24, 2007), the Chairman of the IASB, Sir David Tweedie, noted a similar set of four characteristics, two of which augment the aforementioned six, including whether they: (1) can be explained simply in a matter of a minute or so, and (2) make intuitive sense.

As we continue to deliberate this and other work, we are considering supporting the increased use of objectives-oriented standards.

Future Considerations: We also plan to deliberate what optimal transition provisions should be in the future and whether new standards should be applied prospectively or retrospectively. The goal of such deliberations will be to balance the investor need for consistent information with preparer and auditor concerns about feasibility and the costs of recasting historical information.

Conceptual Approach 2.C: ***In addition to considering the other proposals in this report (and subject to the conclusions reached in our future deliberations of international considerations), we are considering proposing that the SEC encourage a re-prioritization of the standards-setting agenda that balances the need for international convergence, improvements to the conceptual framework, and maintaining existing GAAP. Further, we are deliberating whether the FASB and the SEC should add to their agendas a second phase of the codification project to consider systematically revisiting GAAP to:***

- ***Be more coherent after codification***
- ***Remove conflicts between standards or with the conceptual framework***
- ***Be less complex, where possible***
- ***Be designed more optimally as discussed above***
- ***Readdress frequent practice problems (as identified by restatement volumes, input from the SEC, implementation guidance issued, or frequently asked questions)***
- ***Remove redundancies between SEC disclosure requirements and other sources of GAAP***
- ***Amend, replace, or remove outdated standards.***

As part of our deliberation of the Agenda Advisory Group proposed in section IV of this chapter, we are also deliberating a conceptual approach regarding immediate standards-setting priorities in the current environment. We plan to finalize a proposal after completing deliberations on international considerations later in 2008, which may significantly affect our approach. In fact, some participants in the U.S. financial reporting community have indicated that a full-scale adoption of IFRS in the U.S. may be the most expeditious way to shorten the lengthy timeline that would be required to complete such a list of priorities.

Second Phase of Codification: As noted above, the Codification does not change the substance of GAAP, which continues to be encumbered by detailed rules, bright lines, scope exceptions, industry guidance, accounting alternatives, and other forms of complexity. Because of the evolutionary nature of U.S. standards-setting, the Codification does not read consistently in all parts. Further, even after any needed re-codification of SEC literature proposed in section V of this chapter, there will be opportunities to remove redundancies between SEC and FASB disclosure requirements and make other simplifications. Therefore, we are deliberating whether and when the FASB and the SEC should perform a second phase of the codification project, which

would involve a comprehensive periodic assessment of existing accounting standards like the one we proposed previously in this chapter.

CHAPTER 3: AUDIT PROCESS AND COMPLIANCE

I. Introduction

We have concentrated our efforts to date regarding audit process and compliance on the subjects of financial restatements, including the potential benefits from providing guidance with respect to the materiality[49] and correction of errors; and professional judgment: specifically, whether a judgment framework would enhance the quality of judgments and the willingness of others to respect judgments made.

II. Financial Restatements

II.A. Background

Likely Causes of Restatements

The number of financial restatements[50] in the U.S. financial markets has been increasing significantly over recent years, reaching approximately 1,600 companies in 2006.[51] Restatements generally occur because errors that are determined to be material are found in a financial statement previously provided to the public. Therefore, the increase in restatements appears to be due to an increase in the identification of errors that were determined to be material.

The increase in restatements has been attributed to various causes. These include more rigorous interpretations of accounting and reporting standards by preparers, outside auditors, the SEC, and the PCAOB; the considerable amount of work done by companies to prepare for and improve internal controls in applying the provisions of section 404 of the Sarbanes-Oxley Act; and the existence of control weaknesses that companies failed to identify or remediate. Some have also asserted that the increase in restatements is the result of an overly broad application of the concept of materiality and discussions regarding materiality in SAB 99, *Materiality* (as codified in SAB Topic 1M) – that is, resulting in errors being deemed to be material when an investor may not consider them to be important.

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[49] A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available. *Basic, Inc*. v. *Levinson*, 485 U.S. 224, 231–32 (1988); *TSC Industries, Inc*. v. *Northway, Inc*., 426 U.S. 438, 449 (1976).

[50] For the purposes of this chapter, a restatement is the process of revising previously issued financial statements to reflect the correction of a material error in those financial statements. An amendment is the process of filing a document with revised financial statements with the SEC to replace a previously filed document. A restatement could occur without an amendment, such as when prior periods are revised in a current filing with the SEC.

[51] U.S. Government Accountability Office (GAO) study, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates* (March 2007), and Audit Analytics study, *2006 Financial Restatements A Six Year Comparison* (February 2007).

It is essential that companies, auditors, and regulators strive to reduce the frequency and magnitude of errors in financial reporting. However, the goal is not to reduce the number of restatements per se. Indeed, companies should restate their financial statements to correct errors that are important to current investors. Investors need accurate and comparable data and restatement is the only means to achieve those goals when previously filed financial statements contain material errors. Efforts to improve company controls and audit quality in recent years should reduce errors, and there is evidence this is currently occurring.[52] We believe that public companies should focus on reducing errors in financial statements. At the same time, we believe that some of our developed proposals in the areas of substantive complexity, as discussed in chapter 1, and the standards-setting process, as discussed in chapter 2, will also be helpful in reducing some of the frequency of errors in financial statements.

While reducing errors is the primary goal, it is also important to reduce the number of unnecessary restatements (i.e., those that do not provide important information to current investors). Unnecessary restatements can be costly for companies and auditors, may reduce confidence in reporting, and may create confusion that reduces the efficiency of investor analysis. This portion of this chapter describes our proposals regarding: (1) additional guidance on the concept and application regarding materiality, and (2) the process for and disclosure of the correction of errors.

Our Research

We have considered several publicly-available studies on restatements.[53] We are also aware that the Treasury Department has recently selected University of Kansas Professor Susan Scholz to conduct an examination of the impact of and the reasons for restatements of public company financial statements. We will review the Treasury Department's study and consider its findings as they are made available.

The restatement studies we have reviewed all indicate that the total number of restatements has increased in recent years. Market reaction to restatements may be one indicator as to whether restatements contain information considered by investors to be material. While there are limitations[54] to using market reaction as a proxy for materiality,

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[52] A Glass Lewis & Co. report, *Brief Alert Weekly Trend* (December 17, 2007), shows that restatements in companies subject to section 404 of the Sarbanes Oxley Act have declined for two consecutive years, although the total number of restatements has been increasing.

[53] Studies considered include the GAO study, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates* (March 2007); Glass Lewis & Co. study, *The Errors of Their Ways* (February 2007); and two Audit Analytics studies, *2006 Financial Restatements A Six Year Comparison* (February 2007) and *Financial Restatements and Market Reactions* (October 2007). We have also considered findings from the PCAOB's Office of Research and Analysis's (ORA) working paper, *Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era* (October 18, 2007), understanding that ORA's findings are still preliminary in nature as the study is still going through a peer review process.

[54] Examples of the limitations in using market reaction as a proxy for materiality include (1) the difficultly of measuring market reaction because of the length of time between when the market becomes aware of a potential restatement and the ultimate resolution of the matter, (2) the impact on the market price of factors

based on these studies, it would appear to us that there may be restatements occurring that investors may not consider important due to a lack of a statistically significant market reaction. We, therefore, believe additional guidance on determining whether an error is material and whether a restatement is necessary would be beneficial in reducing the frequency of unnecessary restatements.

We have also considered input from equity and credit analysts and others about investors' views on materiality and how restatements are viewed in the marketplace. Feedback we have received included:

- Bright lines are not really useful in making materiality judgments. Both qualitative and quantitative factors should be considered in determining if an error is material.
- Companies often provide the market with little financial data during the time between a restatement announcement and the final resolution of the restatement. Limited information seriously undermines the quality of investor analysis, and sometimes triggers potential loan default conditions or potential delisting of the company's stock.
- The disclosure provided in connection with restatements is not consistently adequate to allow an investor to evaluate the likelihood of errors in the future. Notably, disclosures often do not provide enough information about the nature and impact of the error, and the resulting actions the company is taking.
- Interim periods should be viewed as more than just a component of an annual financial statement for purposes of making materiality judgments.

II.B. Developed Proposals

Based on our work to date, we believe that, in attempting to eliminate unnecessary restatements, it is helpful to consider two sequential questions: (1) Was the error in the financial statement material to those financial statements when originally filed? and (2) How should a material error in previously issued financial statements be corrected? We believe that framing the principles necessary to evaluate these questions would be helpful. We also believe that in many circumstances investors could benefit from improvements in the nature and timeliness of disclosure in the period between identifying an error and filing restated financial statements.

With this context, we have developed the following proposals regarding the assessment of the materiality of errors to financial statements and the correction of financial statements for errors.[55]

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other than the restatement, and (3) the disclosure at the time of the restatement of other information, such as an earnings release, that may have an offsetting positive market reaction.

[55] We have developed principles that we believe will be helpful in reducing unnecessary restatements. In developing these principles, we have not determined if the principles are inconsistent with existing GAAP, such as SFAS No. 154, *Accounting Changes and Error Corrections*, or APB Opinion No. 28, *Interim Financial Reporting*. To the extent that the implementation of our proposals would require a change to GAAP, the SEC should work with the FASB to revise GAAP.

<u>Developed Proposal 3.1:</u> The FASB or the SEC, as appropriate, should issue guidance reinforcing the following concepts:

- ***Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor.***
- ***Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor.***
- ***Just as qualitative factors may lead to a conclusion that a quantitatively small error is material, qualitative factors also may lead to a conclusion that a quantitatively large error is not material. The evaluation of errors should be on a "sliding scale."***

The FASB or the SEC, as appropriate, should also conduct both education sessions internally and outreach efforts to financial statement preparers and auditors to raise awareness of these issues and to promote more consistent application of the concept of materiality.

We believe that those who judge the materiality of a financial statement error should make the decision based upon the interests, and the viewpoint, of a reasonable investor and based upon how that error impacts the total mix of information available to a reasonable investor. One must "step into the shoes" of a reasonable investor when making these judgments. We believe that too many materiality judgments are being made in practice without full consideration of how a reasonable investor would evaluate the error. When looking at how an error impacts the total mix of information, one must consider all of the qualitative factors that would impact the evaluation of the error. This is why bright lines or purely quantitative methods are not appropriate in determining the materiality of an error to annual financial statements. It is possible that an error that results in a misclassification on the income statement (without a change in net income) may not be deemed to be material, while an error of the same magnitude that impacts net income may be deemed material based on the effect of the error on the total mix of information available to a reasonable investor.

We believe that, in current practice, materiality guidance such as SAB Topic 1M is interpreted as being one-directional in that qualitative considerations can make a quantitatively small error material, but a quantitatively large error is material without regard to qualitative factors. We believe that qualitative factors not only can increase, but also can decrease, the importance of an error to the reasonable investor. Specifically, we believe that there should be a "sliding scale" for evaluating errors. On this scale, the higher the quantitative significance of an error, the stronger the qualitative factors must be to result in a judgment that the error is not material. Conversely, the lower the quantitative significance of an error, the stronger the qualitative factors must be to result in a judgment that the error is material.

The following are examples of some of the qualitative factors that could result in a conclusion that a large error is not material. (Note that this is not an exhaustive list of factors, nor should this list be considered a "checklist" whereby the presence of any one

of these items would make an error not material. Companies and their auditors should continue to look at the totality of all factors when making a materiality judgment):

- The error impacts metrics that do not drive reasonable investor conclusions or are not important to reasonable investor models.
- The error is a one time item and does not alter investors' perceptions of key trends affecting the company.
- The error does not impact a business segment or other portion of the registrant's business that investors regard as driving valuation or risks.
- The error relates to financial statement items whose measurement is inherently highly imprecise.

Education and outreach efforts can be instrumental in increasing the awareness of these concepts and ensuring more consistent application of materiality. Many of the issues with materiality in practice are caused by misunderstandings by preparers, auditors and regulators. Elimination of these misunderstandings would be a significant step toward reducing unnecessary restatements.

Developed Proposal 3.2: ***The FASB or the SEC, as appropriate, should issue guidance on how to correct an error consistent with the principles outlined below:***

- ***Prior period financial statements should only be restated for errors that are material to those prior periods.***
- ***The determination of how to correct a material error should be based on the needs of current investors. For example, a material error that has no relevance to a current investor's assessment of the annual financial statements would not require restatement of the annual financial statements in which the error occurred, but would need to be disclosed in an appropriate document, and, to the extent that the error remains uncorrected in the current period, corrected in the current period.***
- ***There may be no need for the filing of amendments to previously filed annual or interim reports to reflect restated financial statements, if the next annual or interim period report is being filed in the near future and that report will contain all of the relevant information.***
- ***Restatements of interim periods do not necessarily need to result in a restatement of an annual period.***
- ***All errors, other than clearly insignificant errors, should be corrected no later than in the financial statements of the period in which the error is discovered. All material errors should be disclosed when they are corrected.***
- ***The current disclosure during the period in which the restatement is being prepared, about the need for a restatement and about the restatement itself, is not consistently adequate for the needs of investors and should be enhanced.***

The current guidance that is detailed in SAB 108 (as codified in SAB Topic 1N) may result in the correction of prior annual periods for immaterial errors occurring in those periods because the cumulative effect of these prior period errors would be material to the current annual period, if the prior period errors were corrected in the current annual period. In the process of reflecting these immaterial corrections to prior annual periods,

some believe that the prior annual period financial statements should indicate that they have been restated. There is diversity in practice on this issue, and clarification is needed from the SEC on the intent of SAB Topic 1N. We believe that prior annual period financial statements should not be restated or corrected for errors that are immaterial to the prior annual period. Instead of the approach specified in Topic 1N, we believe that, where errors are not material to the prior annual periods in which they occurred but would be material if corrected in the current annual period, the error could be corrected in the current annual period[56] with appropriate disclosure at the time the current annual period financial statements are filed with the SEC.

We believe that the determination of how errors should be corrected should be based on the needs of current investors. This determination should be based on the facts and circumstances of each error. For example, an error that does not affect the annual financial statements included within a company's most recent filing with the SEC may be determined to not be relevant to current investors. For errors that do not require restatement but were material in the annual period in which they occurred, companies could be required to provide appropriate disclosure about the error and the periods impacted.

For material errors that are discovered within a very short time period prior to a company's next regularly scheduled reporting date, it may be appropriate in certain instances to report the restatement in the next filing with appropriate disclosure of the error and its impact on prior periods, instead of amending previous filings with the SEC. This option should be further studied with regard to the possibility of abuse and, if appropriate, should be included in the overall guidance on how to correct errors.

Assuming that there is an error in an interim period within an annual period for which financial statements have previously been filed with the SEC, the following guidance should be utilized:

- If the error is not material to either the previously issued interim period or to the previously issued annual period, the previously issued financial statements should not be restated.
- If the prior period error is determined to be material only to the previously issued interim period, but not the previously issued annual period, then only the previously issued interim period should be restated (i.e., the annual period that is already filed should not be restated and the Form 10-K should not be amended). However, there should be appropriate disclosure in the company's next Form 10-K to explain the discrepancy in the results for the interim periods during the previous annual period on an aggregate basis and the reported results for that annual period.

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[56] We are focused on the principle that prior periods should not be restated for errors that are not material to those periods. Correction in the current period for errors that are not material to prior periods could be accomplished through an adjustment to equity or to current period income (which might potentially require an amendment to GAAP). We believe that there are merits in both approaches and that the FASB and the SEC, as appropriate, should carefully weigh both approaches before determining the actual approach to utilize.

We believe that all errors, excluding clearly insignificant errors, should be corrected no later than in the financial statements of the annual or interim period in which the error is discovered. That being said, there should be a practicality exception for immaterial errors discovered shortly before the issuance of the financial statements, but in this case, the errors should be corrected in the next annual or interim period being reported upon.[57] Nevertheless, all material errors should be disclosed during the period in which they are corrected.

Typically, the restatement process involves three primary reporting stages:

1. The initial notification to the SEC and investors that there is a material error and that the financial statements previously filed with the SEC can no longer be relied upon;
2. The "dark period" or the period between the initial notification to the SEC and the time restated financial statements are filed with the SEC; and
3. The filing of restated financial statements with the SEC.

We believe that a major effect on investors due to restatements is the lack of information when companies are silent during stage 2, or the "dark period." This silence creates significant uncertainty regarding the size and nature of the effects on the company of the issues leading to the restatement. This uncertainty often results in decreases in the company's stock price. In addition, delays in filing restated financial statements may create default conditions in loan covenants; these delays may adversely affect the company's liquidity. We understand that, in the current legal environment, companies are often unwilling to provide disclosure of uncertain information. However, we believe that when companies are going through the restatement process, they should be encouraged to continue to provide any reasonably reliable financial information that they can, accompanied by appropriate explanations of ways in which the information could be affected by the restatement. Consequently, regulators should evaluate the company's disclosures during the "dark period" taking into account the difficulties of generating reasonably reliable information before a restatement is completed.

We believe that the current disclosure surrounding a restatement is often not adequate to allow investors to evaluate the company's operations and the likelihood that such errors could occur in the future. Specifically, we believe that all companies that have a restatement should be required to disclose information related to: (1) the nature of the error, (2) the impact of the error, and (3) management's response to the error, to the extent known, during all three stages of the restatement process. Some suggestions of disclosures that would be made by companies include the following:

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[57] We understand that sometimes there may be immaterial differences between a preparer's estimate of an amount and the independent auditor's estimate of an amount that exist when financial statements are issued. These differences might or might not be errors, and may require additional work to determine the nature and actual amount of the error. This additional work is not necessary for the preparer or the auditor to agree to release the financial statements. Due care should be taken in developing any guidance in this area to provide an exception for these legitimate differences of opinion, and to ensure that any requirement to correct all "errors" would not result in unnecessary work for preparers or auditors.

Nature of error

- Description of the error
- Periods affected and under review
- Material items in each of the financial statements subject to the error and pending restatement
- For each financial statement line item, the amount of the error or range of potential error
- Identity of business units/locations/segments/subsidiaries affected

Impact of error

- Updated analysis on trends affecting the business if the error impacted key trends
- Loan covenant violations, ability to pay dividends, and other effects on liquidity or access to capital resources
- Other areas, such as loss of material customers or suppliers

Management Response

- Nature of the control weakness that led to the restatement and corrective actions, if any, taken by the company to prevent the error from occurring in the future
- Actions taken in response to covenant violations, loss of access to capital markets, loss of customers, and other consequences of the restatement

If there are material developments related to the restatement, companies should update this disclosure on a periodic basis during the restatement process, particularly when quarterly or annual reports are required to be filed, and provide full and complete disclosure within the filing with the SEC that includes the restated financial statements.

We believe that the issuance by the FASB or the SEC, as appropriate, of guidance on how to correct and disclose errors in previously issued financial statements will provide to investors higher quality information (e.g., prior periods would not be restated for immaterial items and for errors that have no relevance to current investors, and more consistently good disclosure would be made during and about the restatement process) and reduce the burdens on companies related to unnecessary restatements. In addition, since our proposals would require that all material errors be disclosed, relevant information about such errors would be communicated to investors.

Developed Proposal 3.3: ***The FASB or the SEC, as appropriate, should develop and issue guidance on applying materiality to errors identified in prior interim periods and how to correct these errors. This guidance should reflect the following principles:***

- ***Materiality in interim period financial statements must be assessed based on the perspective of the reasonable investor***
- ***When there is a material error in an interim period, the guidance on how to correct that error should be consistent with the principles outlined in developed proposal 3.2.***

Based on prior restatement studies, approximately one-third of all restatements involved only interim periods. Authoritative accounting guidance on assessing materiality with respect to interim periods is currently limited to paragraph 29 of APB Opinion No. 28, *Interim Financial Reporting*.[58] Differences in interpretation of this paragraph have resulted in variations in practice that have increased the complexity of financial reporting. This increased complexity impacts preparers and auditors, who struggle with determining how to evaluate the materiality of an error to an interim period, and also impacts investors, who can be confused by the inconsistency between how companies evaluate and report errors. We believe that guidance as to how to evaluate errors related to interim periods would be beneficial to preparers, auditors and investors.

We have observed that a large part of the dialogue about interim materiality has focused on whether an interim period should be viewed as a discrete period or an integral part of an annual period. Consistent with the view expressed at the outset of this section, we believe that the interim materiality dialogue could be greatly simplified if that dialogue were refocused to address two sequential questions: (1) What principles should be considered in determining the materiality of an error in interim period financial statements? and (2) How should errors in previously issued interim financial statements be corrected? We believe that additional guidance on these questions, which are extensions of the basic principles outlined in developed proposals 3.1 and 3.2 above, would provide useful guidance in assessing and correcting interim period errors. We believe that while these principles would assist in developing guidance related to interim periods, additional work should also be performed to fully develop robust guidance regarding errors identified in interim periods.

We believe that the determination of whether an interim period error is material should be made based on the perspective of a reasonable investor, not whether an interim period is a discrete period, an integral part of an annual period, or some combination of both. An interim period is part of a larger mix of information available to a reasonable investor. As one example, a reasonable investor would use interim financial statements to assess the sustainability of a company's operations and cash flows. In this example, if an error in interim financial statements did not impact the sustainability of a company's operations and cash flows, the interim period error may very well not be material given the total mix of information available. Similarly, just as a large error in annual financial statements does not determine by itself whether an error is material, the size of an error in interim financial statements should also not be necessarily determinative as to whether an error in interim financial statements is material.

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[58] Paragraph 29 of APB Opinion No. 28, *Interim Financial Reporting*, states the following:

> In determining materiality for the purpose of reporting the cumulative effect of an accounting change or correction of an error, amounts should be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.

We believe that applying the principles set forth above would reduce restatements by providing a company the ability to correct in the current period immaterial errors in previously issued financial statements and as a practical matter obviate the need to debate whether the interim period is a discrete period, an integral part of an annual period, or some combination of both.

We also note that these principles will provide a mechanism, other than restatement, to correct through the current period a particular error that has often been at the center of the interim materiality debate – a newly discovered error that has accumulated over one or more annual or interim periods, but was not material to any of those prior periods.

III. Professional Judgment

III.A. Background

Overview

Professional judgment is not new to the areas of accounting, auditing, or securities regulation – the criteria for making and evaluating professional judgment have been a topic of discussion for many years. The recent increased focus on professional judgment, however, comes from several different developments, including changes in the regulation of auditors and a focus on more "principles-based" standards – for example, FASB standards on fair value and IASB standards. Investors will benefit from more emphasis on "principles-based" standards, since "rules-based" standards (as discussed in chapters 1 and 2) may provide a method, such as through exceptions and bright-line tests, to avoid the accounting objectives underlying the standards. If properly implemented, "principles-based" standards should improve the information provided to investors while reducing the investor's concern about "financial engineering" by companies using the "rules" to avoid accounting for the substance of a transaction. While both auditors and issuers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by auditors and regulators in evaluating judgments does not provide an environment in which such judgments may be generally respected. This, in turn, can lead to repeated calls for more rules, so that the standards can be comfortably implemented.

Many regulators also appear to encourage a system in which professionals can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction. Regulators assert that they do respect judgments, but may also express concerns that some companies and auditors may attempt to inappropriately defend certain errors as "reasonable judgments." Identifying standard processes for making professional judgments and criteria for evaluating those judgments, after the fact, may provide an environment that promotes the use of judgment and encourages consistent evaluation practices among regulators.

Goals of a Framework

The following are several issues that a potential framework may help address:

a. Investors' lack of confidence in the use of judgment – A professional judgment framework may provide investors with greater comfort that there is an acceptable rigor that companies follow in exercising reasonable professional judgment.

b. Preparers' and auditors' concern regarding whether reasonable judgments are respected – In the current environment, preparers and auditors may be afraid to exercise judgment for fear of having their judgments overruled, after the fact, by auditors, regulators and legal claimants.

c. Lack of agreement in principle on the criteria for evaluating judgments – The criteria for evaluating reasonable judgment, including the appropriate role of hindsight in the evaluation, may not be clearly defined and thus may lead to increased uncertainty.

d. Concern over increased use of "principles-based" standards – Companies, auditors and investors may be less comfortable in their ability to implement more "principles-based" standards if there is a concern over how reasonable judgments are reached and how they will be assessed.

Categories of Judgments that are Made in Preparing Financial Statements

There are many categories of accounting and auditing judgments that are made in preparing financial statements, and a framework should encompass all of these categories, if practicable. Some of the categories of accounting judgment are as follows:

1. Selection of accounting standard

   In many cases, the selection of the appropriate accounting standard under GAAP is not a highly complex judgment (e.g., leases would be accounted for using lease accounting standards and pensions would be accounted for using pension accounting standards). However, there are cases in which the selection of the appropriate accounting standard can be highly complex.

   For example, the standards on accounting for derivatives contain a definition of a derivative and provide scope exceptions that limit the applicability of the standard to certain types of derivatives. To evaluate how to account for a contract that has at least some characteristics of a derivative, one would first have to determine if the contract met the definition of a derivative in the accounting standard and then determine if the contract would meet any of the scope exceptions that limited the applicability of the standard. Depending on the nature and terms of the contract, this could be a complex judgment to make, and one on which experienced accounting professionals can have legitimate differing, yet acceptable, opinions.

2. Implementation of an accounting standard

   After the correct accounting standard is identified, there are judgments to be made during its implementation.

   Examples of implementation judgments include determining if a hedge is effective, if a lease is an operating or a capital lease, and what inputs and methodology should be utilized in a fair value calculation. Implementation judgments can be assisted by implementation guidance issued by standards-setters, regulators, and other bodies; however, this guidance could increase the complexity of selecting the correct accounting standard, as demonstrated by the guidance issued on accounting for derivatives.

   Further, many accounting standards use wording such as "substantially all" or "generally." The use of such qualifying language can increase the amount of judgment required to implement an accounting standard. In addition, some standards may have potentially conflicting statements.

3. Lack of applicable accounting standards

   There are some transactions that may not readily fit into a particular accounting standard. Dealing with these "gray" areas of GAAP is typically highly complex and requires a great deal of judgment and accounting expertise. In particular, many of these judgments use analogies from existing standards that require a careful consideration of the facts and circumstances involved in the judgment.

4. Financial Statement Presentation

   The appropriate method to present, classify and disclose the accounting for a transaction in a financial statement can be highly subjective and can require a great deal of judgment.

5. Estimating the actual amount to record

   Even when there is little debate as to which accounting standard to apply to a transaction, there can be significant judgments that need to be made in estimating the actual amount to record.

   For example, opinions on the appropriate standard to account for loan losses or to measure impairments of assets typically do not differ. However, the assumptions and methodology used by management to actually determine the allowance for loan losses or to determine an impairment of an asset can be a highly judgmental area.

6. Evaluating the sufficiency of evidence

   Not only must one make a judgment about how to account for a transaction, the sufficiency of the evidence used to support the conclusion must be evaluated. In practice, this is typically one of the most subjective and difficult judgments to make.

   Examples include determining if there is sufficient evidence to estimate sales returns or to support the collectability of a loan.

Levels of Judgment

There are many levels of judgment that occur related to accounting and auditing. Preparers must make initial judgments about uncertain accounting issues; the preparer's judgment may then be evaluated or challenged by auditors, investors, regulators, legal claimants, and even others, such as the media. Similarly, planning and performing an audit requires numerous judgments. These judgments are also potentially subject to evaluation and challenge by investors, regulators, legal claimants and others, especially when, in hindsight, it has become clear that the auditor failed to detect material errors in the financial statements. Therefore, in developing a potential framework, differences in role and perspective between those who make a judgment and those who evaluate a judgment should be carefully considered. A framework should not make those who evaluate a judgment (auditors, regulators, and others) re-perform the judgment according to the framework. Instead, a framework should provide guidance to those who would evaluate a judgment on factors to consider while making that evaluation.

Hindsight

One appropriate tool used in auditing is hindsight – the ability of the auditor to use facts that are available through the completion of the audit work to evaluate the sufficiency of management's estimates and assumptions based on actual facts that become available after those estimates are made.

For example, auditors will frequently test the accuracy of the company's accounts payable balance at period-end by looking at cash disbursements made after the period-end. This evidence allows the auditor to determine whether the accrual for unpaid expenses at year-end is adequate.

However, the use of hindsight to evaluate a judgment where the relevant facts were not available at the time of the initial release of the financial statements (including interim financial statements) is not appropriate. Determining at what point the relevant facts were known to management or the auditor, *or should have been known*,[59] can be difficult, particularly for regulators who are often evaluating these circumstances after substantial

[59] We believe that those making a judgment should be expected to exercise due care in gathering all of the relevant facts prior to making the judgment.

time has passed. Therefore, the use of hindsight should only be used based on the facts reasonably available at the time the annual or interim financial statements were issued.

Form of Framework

Some have proposed that a "safe harbor" be developed that protects the exercise of judgment in accordance with a specified framework. That approach would seem to provide greater support to auditors and preparers than a statement of policy. However, it is unclear to us whether a legal or regulatory safe harbor (i.e., an effective legal or regulatory defense based on conformity with the framework) could be adopted by the SEC or whether it would require changes to existing statutes.

Another approach is for the SEC and the PCAOB to issue policy statements that describe a framework for the exercise of professional judgment and state that auditors, the SEC or the PCAOB, as applicable, would take into account the implementation of the framework in evaluating a judgment made by a registrant or an auditor. The SEC has utilized similar frameworks in the past with success. Examples of previous frameworks by the SEC include the "Seaboard" report (October 23, 2001) on the relationship of cooperation by a company to taking action in an enforcement case and the SEC's framework for assessing the appropriateness of corporate penalties (January 4, 2006).

While not an automatic defense of the registrant's or auditor's judgment, a framework would provide more support to registrants and auditors that the applicable regulator would be likely to accept a judgment made if the registrant or the auditor had fully implemented the framework. The framework is likely to enhance the quality of judgments by providing incentives to follow a rigorous process for making accounting and auditing judgments. The increased use of this rigorous process should, in turn, provide more comfort to investors about the quality of accounting judgments made in connection with financial statements.

It is unclear to us whether, as a matter of regulatory strategy, this judgment framework should be implemented through a safe harbor or policy statement. We leave to the SEC and its staff the resolution of these difficult issues.

The Nature and Limitations of GAAP:

Some have suggested that the standard in a potential professional judgment framework for the selection and implementation of GAAP be a requirement to reflect the economic substance of a transaction or be a standard of selecting the "high road" in accounting for a transaction. We agree that qualitative standards for GAAP such as these would be desirable and we encourage regulators and standards-setters to move financial reporting in this direction. However, such standards are not always present in financial reporting today and we cannot recommend the adoption of such standards in a professional judgment framework without anticipating a fundamental long-term revision of GAAP – a change that would be beyond our purview and one that would not be doable in the near- or intermediate-term.

For example, there is general agreement that accounting should follow the substance and not just the form of a transaction or event. Many believe that this fundamental principle should be extended to require that all GAAP judgments should reflect economic substance. However, reasonable people disagree on what economic substance actually is, and many would conclude that significant parts of current GAAP do not require and do not purport to measure economic substance (e.g., accounting for leases, pensions, certain financial instruments and internally developed intangible assets are often cited as examples of items reported in accordance with GAAP that would not meet many reasonable definitions of economic substance).

Similarly, some would like financial reporting to be based on the "high road" – a requirement to use the most preferable principle in all instances. Unfortunately, today a preparer is free to select from a variety of acceptable methods allowed by GAAP (e.g., costing inventory, measuring depreciation, and electing to apply hedge accounting are just some of the many varied methods allowed by GAAP) without any qualitative standard required in the selection process. In fact, a preferable method is required to be followed only when a change in accounting principle is made, and a less preferable alternative is fully acceptable absent such a change.

We believe that adopting a requirement that accounting judgments reflect economic substance or the "high road" would require a revolutionary change not achievable in the foreseeable future. Our suggested judgment framework could and we believe would enhance adherence to GAAP, but it cannot be expected to correct inherent weaknesses in the standards to which it would be applied.

III.B. Developed Proposals

We have developed the following proposal:

Developed Proposal 3.4: ***The SEC should adopt a judgment framework for accounting judgments. The PCAOB should also adopt a similar framework with respect to auditing judgments. Careful consideration should be given in implementing any framework to ensure that the framework does not limit the ability of auditors and regulators to ask appropriate questions regarding judgments and take actions to require correction of unreasonable judgments.***

The proposed framework applicable to accounting-related judgments would include the choice and application of accounting principles, as well as the estimates and evaluation of evidence related to the application of an accounting principle. We believe that a framework that is consistent with the principles outlined in this developed proposal to cover judgments made by auditors based on the application of PCAOB auditing standards would be very important and would be beneficial to investors, preparers, and auditors. Therefore, we propose that the PCAOB develop a professional judgment framework for the application and evaluations of judgments made based on PCAOB auditing standards.

We propose that the framework for accounting judgments be consistent with the following concepts:

Framework for Professional Judgment in Accounting

The Concept of Professional Judgment

Professional judgment, with respect to accounting matters, should be the outcome of a process in which a person or persons with the appropriate level of knowledge, experience, and objectivity form an opinion based on the relevant facts and circumstances within the context provided by applicable accounting standards. Professional judgments could differ between knowledgeable, experienced, and objective persons. Such differences between reasonable professional judgments do not, in themselves, suggest that one judgment is wrong and the other is correct. Therefore, those who evaluate judgments should evaluate the reasonableness of the judgment, and should not base their evaluation on whether the judgment is different from the opinion that would have been reached by the evaluator.

This framework would serve as the primary, though not exclusive, approach to evaluating the process of making professional judgments. While regulators would strongly support the principles of this framework, the mere completion of the process outlined in the framework in making a judgment would not prevent an auditor and/or regulator from asking appropriate questions about the judgment or asking companies to correct unreasonable judgments. A judgment framework would not eliminate debate, nor should it attempt to do so. Rather, it organizes analysis and focuses preparers and others on areas to be addressed thereby improving the quality of the judgment and likelihood that auditors[60] and regulators will accept the judgment. Conversely, not following the framework would not imply that the judgment is unreasonable.

This framework reflects the fact that GAAP does not always reflect the economic substance of a transaction and that it may be difficult to determine how the accounting would meet the needs of investors. In addition, this framework would be applicable to accounting matters only to the extent that judgments were required in the choice or application of accounting principles, in estimating the amount to record, or in evaluating the sufficiency of the evidence.

In applying the components of the framework, it would be expected that the amount of documentation, disclosure, input from professional experts,[61] and level of effort in

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[60] It should be noted that, while auditors should be using the framework to evaluate a client's judgments and should respect reasonable judgments, they still have a requirement to follow PCAOB auditing standards, which would include expressing an opinion regarding whether the client's financial statements are fairly presented, in all material respects, in accordance with GAAP. Therefore, this framework would not require auditors to issue an unqualified audit opinion when they disagree with a judgment.

[61] In many cases, input from professional experts would include consultation with a preparer's independent auditors.

making a professional judgment would vary based on the complexity, nature (routine versus non-routine) and materiality of a transaction or issue requiring judgment.

Components of a Framework

Critical and Good Faith Thought Process – Professional judgment should be based on a critical and reasoned evaluation made in good faith, prior to the exercise of the judgment, of an identified issue, including the nature and scope of the issue based on:

1. An analysis of the transaction, including the substance and business purpose of the transaction
2. The material facts reasonably available at the time that the financial statements are issued
3. A thorough review and analysis of relevant literature, including the relevant underlying principles
4. Alternative views or estimates, including pros and cons for reasonable alternatives
5. The rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties
6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated
7. Known diversity in practice regarding the alternatives or estimates[62]
8. The consistency of application of alternatives or estimates to similar transactions
9. The appropriateness and reliability of the assumptions and data used.

The critical thought process should include input from personnel with an appropriate level of professional expertise and should include a sufficient amount of time and effort to properly consider the judgment.

Material issues or transactions that were analyzed pursuant to the application of the framework should be disclosed in accordance with existing disclosure requirements. This disclosure should be transparent so that the investor understands the transaction and assumptions that were critical to the judgment. When evaluating professional judgment, auditors, and/or regulators should take into account the disclosure relevant to the judgment.

Documentation – The alternatives considered and the conclusions reached should be documented contemporaneously. The lack of contemporaneous documentation may not mean that a judgment was incorrect, but would complicate an explanation of the nature and propriety of a judgment made at the time of the release of the financial statements.

[62] If there is not diversity in practice, it would be significantly harder to select a different alternative.

IV. Future Considerations

We intend to examine the area of regulation and compliance for issues that create avoidable complexity in financial reporting. Some of the areas that we intend to focus on include: (1) the interaction between companies and their auditors, the SEC, and the PCAOB, (2) the interaction between audit firms and the SEC and PCAOB, and (3) the levels of enforcement and regulation of standards in other developed markets around the world.

CHAPTER 4: DELIVERING FINANCIAL INFORMATION

I. Introduction

We have been evaluating the information needs of investors, methods by which financial information is provided to investors, and means to improve delivery of financial information to all market constituencies. In evaluating the information needs of investors, we have recognized that the information needs of different types of investors are not always the same. We have agreed that information must be delivered in a manner that is efficient, reliable, and cost-effective for each of the relevant investor groups and will not significantly increase burdens on reporting companies.

We have determined that we will focus our efforts on financial information provided by reporting companies in their periodic and current reports under the Securities Exchange Act of 1934 ("Exchange Act") and other ongoing disclosures provided by reporting companies to investors and the market.[63] We believe that we can make some useful proposals to enhance ongoing reporting that will enable investors to better understand reporting companies.

Based on the above, we have analyzed two ways to improve the delivery of financial information to investors and the market. These are:

- Tagging of financial information (XBRL)
- Improving corporate website use.

We also intend to look at the following in the future:

- Use of executive summaries as an integral part of Exchange Act periodic reports
- Disclosures of key performance indicators (KPIs) and other metrics to enhance business reporting
- Improved quarterly press release disclosures and timing
- Continued need for improvements in the management discussion and analysis (MD&A) and other public company financial disclosures.

[63] We have determined that we will not to address information delivery in registered offerings under the Securities Act of 1933 for two primary reasons. First, the SEC already has addressed information delivery in registered securities offerings when it adopted new communication rules in 2005 for registered offerings by issuers other than registered investment companies. Second, we view information delivery relating to ongoing company reporting by public companies as the area needing greater focus.

II. Tagging of Financial Information (XBRL)

II.A. Background

Description of XBRL

XBRL is an international information format standard designed to help investors and analysts find, understand, and compare financial and non-financial information by making this information machine-readable. It enables companies to better control how their financial or non-financial information is presented and disseminated and reduce reporting costs by integrating their operating data with their financial reporting disclosure. XBRL is a computer language which uses standardized XML (eXtensible Markup Language) technology and permits the automation of what are now largely manual steps for access, validation, analysis, and reporting of disclosure. For example, an investor or analyst who wants to compare the sales of all pharmaceutical companies will be able to use software applications to take the XBRL-tagged information, extract the sales numbers and download them directly to a spreadsheet.

XBRL uses standardized definitions of terms, like a dictionary. The standardized terms are then arranged in a logical structure called a taxonomy. A GAAP financial statement itself, in that its underlying details are summarized in the line items of a balance sheet or income statement, is a kind of taxonomy. There are taxonomies for different kinds of businesses. For example, the banking industry sector taxonomy differs from that of a software industry sector company.

Status of XBRL-Tagged Financial Statements in SEC Reports

The SEC has adopted a voluntary pilot program for the use of XBRL in which participants submit voluntarily supplemental tagged financial information using the XBRL format as exhibits to specified EDGAR filings.[64] Voluntary pilot participants may use existing standard XBRL taxonomies. Over four dozen companies are participating in the pilot program and have agreed to voluntarily submit their annual, quarterly and other reports with interactive data for a period of one year. The SEC recently expanded the voluntary filing program to include mutual funds which will file using a risk and return taxonomy developed by the Investment Company Institute.

On December 5, 2007, XBRL-US published a draft XBRL U.S. GAAP Taxonomy and draft preparer's guide for public testing and comment. The XBRL U.S. GAAP Taxonomy includes tags for a company's financial statements and notes. Public review currently is scheduled to end April 5, 2008, and XBRL-US has stated that it anticipates that the final XBRL U.S. GAAP Taxonomy and preparer guidance will be issued in

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[64] The SEC's voluntary XBRL rules specify the form, content, and format of XBRL submissions, description of XBRL data, timing of XBRL submissions, and use of Taxonomies. For example, the rules require the tagged data to be described either as "unaudited" or, for quarterly financial statements, "unreviewed."

spring 2008. After the final XBRL U.S. GAAP Taxonomy and preparer guidance is issued, the SEC EDGAR system must be modified to accept submissions tagged using the XBRL U.S. GAAP Taxonomy.

The SEC has stated that it will use the initial financial statements prepared using the new XBRL U.S. GAAP Taxonomy to help it further update its EDGAR system so that it will be able to "seamlessly accept and render the filings." We understand that currently, the SEC's EDGAR system does not yet accept and render financial statements with XBRL tags based on the newly-developed XBRL U.S. GAAP Taxonomy.

In addition, we understand that the software industry has been engaged in developing tagging and rendering (turning the XBRL-tagged information into a human readable format) software for XBRL-tagged financial statements. Companies generally use two methods to tag their financial statements using XBRL. The first method, called a "bolt-on" approach, involves developing the XBRL reports after the filed financial statements are developed – a process known as "mapping." Companies also may use XBRL as part of an integrated approach to financial reporting. In an integrated approach, companies incorporate XBRL into their internal company financial systems which allows financial reports to be created from the XBRL-tagged financial systems, without first preparing such financial statements in "human readable format." XBRL-tagging using a "bolt-on" approach may involve somewhat more effort than using an integrated approach. Currently, there is software that allows companies to XBRL-tag their financial statements using the "bolt-on" approach.[65] At this time it is unknown how many companies have begun integrating XBRL-tagging into their internal financial reporting systems and, therefore, it is not clear when a significant number of companies would move from a "bolt-on" to an integrated approach to XBRL-tagging of their financial statements.

Time and Costs Involved in XBRL-Tagging

We understand that while the XBRL U.S. GAAP Taxonomy has a significant number of individual tags or elements, it contains all of the terms or concepts commonly used in financial statements prepared in accordance with GAAP. We understand that reporting companies would use only a limited number of tags or elements. For example, one large voluntary filer uses approximately 192 tags (it tags its notes as blocks rather than at a granular level) to tag its Form 10-Q. We understand that there may be the need for customized "extensions" if the XBRL U.S. GAAP Taxonomy does not include a tag for the particular item in the company's financial statements. Because the XBRL U.S. GAAP Taxonomy currently out for public comment tracks GAAP, we believe that there likely will be less need for customized extension elements. One of the purposes of the comment period on the XBRL U.S. GAAP Taxonomy and preparer guidance is to identify additional tags or elements that should be added to the XBRL U.S. GAAP Taxonomy, reducing the need for customized extensions. The draft preparer guidance out for public comment also will be evaluated by preparers, investors, and others to

[65] Using the "bolt-on" method, companies can prepare their financial statements (including notes) in a number of formats, such as Adobe (pdf), Word, and HTML.

determine whether it provides adequate guidance for determining when an extension should be used by preparers.

The type of information that is tagged also is relevant to understanding XBRL-tagged financial statements. Companies participating in the voluntary program have been tagging the face of their financial statements using existing taxonomies and software. As to the notes to the financial statements, additional effort may be involved. While the notes to the financial statements may easily be tagged as a block of text, unlike preparation of notes to the financial statements in a paper-based format, tagging the individual information in each note will involve additional tags and, therefore, more work than block-tagging the text.

Certain preparers participating in the SEC's voluntary program have indicated that the initial number of hours it took to tag the face of their financial statements using existing standard taxonomies (not the new XBRL U.S. GAAP Taxonomy) and a "bolt-on" approach ranged from 80-100 hours and that the number of hours dropped significantly for subsequent reports (due to the lack of a need to replicate the tagging process for most items).[66] For preparers also tagging the notes to their financial statements using a "block" tag, the number of hours increased slightly. The costs to tag the face of the financial statements using standardized software were not significant. Additional time and cost was spent by at least one preparer to validate the tags that were used. In these cases, there was no auditor involvement in the process.

Smaller Public Company Reactions to XBRL-Tagging

Smaller public company representatives recognize the benefits that XBRL offers their companies over the long-term, but are concerned about initial implementation costs, which could be alleviated with the development of improved tagging and verification software. The representatives strongly support a phase-in approach in which such smaller public companies would be included at the end, once larger public companies had worked through any significant implementation issues, including use of company resources involved in tagging and verification of XBRL tags.

Potential Benefits of XBRL

We see a number of potential benefits of XBRL for reporting companies and investors of financial and non-financial information. First, XBRL-tagging could benefit reporting companies by permitting improved communications with analysts and investors. Released corporate data could be instantaneously and immediately usable by analysts in their models without the need for them to wait for third party aggregators or staff to input the data into their own format. There would be a reduction in search costs. Further, such reduced search costs could potentially increase coverage of companies, especially mid-

[66] For example, one S&P 500 company participating in the voluntary pilot spent 80 hours learning the tagging tool, understanding SEC requirements, creating extensions for tags, and creating a process for ongoing tagging and future submissions.

size and smaller companies, by sell-side and buy- side analysts, and at both major brokerage and independent research firms. XBRL-tagging also would likely improve the quality of data[67] and the ability of a company to control the presentation of its financial information. The elimination or reduction of the manual input would likely reduce error rates in reporting and inputting of corporate data by aggregators.

Second, XBRL has the potential to improve the integration of company operating and reporting data. Using XBRL, operating data can be accessed in the internal enterprise applications where it is regularly stored, and thus will be used for financial reporting purposes without the necessity of downloading to paper or manual search. The same electronically accessible data can be used for other purposes beyond those of financial statements, including tax, industrial filings, audit, benchmarking, performance reporting, internal management, and sustainability. We believe that the full economic benefits of XBRL will most likely come when companies incorporate XBRL into their internal reporting, instead of using it as a "bolt-on" after their financial reports are prepared.

Finally, XBRL-tagged financial statements can provide a number of benefits to investors, including both retail investors and the "model builder/research analyst." Investors can benefit from, among other things, a reduced cost of locating and inputting data into analytical frameworks, elimination of manual input thereby reducing the likelihood of input error by an investor or data aggregator, reduced investor dependence on proprietary and inconsistent data sources, increased likelihood of more investors utilizing primary data sources, and reduced cost of and improved company comparisons. The XBRL-tagged financial statements should enable investors and experienced analysts at research organizations to spend more time analyzing data than data gathering.

We recognize, however, that notwithstanding the potential benefits, many company officers may not understand how XBRL works or what improvements it could bring to both their financial reporting and their costs of reporting. In addition, there currently is limited acceptance of XBRL due, in part, to companies needing greater certainty that XBRL will be adopted before they will expend the necessary resources to understand it and its benefits. Companies may have other concerns about potential start-up costs in adopting XBRL, including purchase of software and personnel resources for data input and training. Further, analysts and software developers generally are unaware or uninformed about XBRL.

Implementation of XBRL-Tagging of Financial Statements

We believe that the SEC should, over the long-term, require all public reporting companies (preparing their financial statements using GAAP) to tag the financial statements (including footnotes) they are required to file with the SEC as part of their Exchange Act reports using XBRL. We believe that an implementation roadmap from

[67] Although XBRL is frequently called "interactive data," the use of the term "data" should not be deemed to imply numerical data alone. XBRL also is useful for the tagging of narrative information.

the SEC is needed to encourage the involved parties to move beyond a wait-and-see approach and commit resources toward the necessary development of software. That software would tag financial information and enable the viewing and reading of the XBRL-tagged information, the use of XBRL-tagged data by investors such as analysts and investors, and the integration of XBRL by companies. We believe that full implementation of mandated XBRL-tagged financial statements will require a phase-in over a period of time, as discussed below, to enable preparers and investors to understand XBRL by preparers and investors, to permit successful use of the new XBRL U.S. GAAP Taxonomy, and to enable the further development of tagging and rendering software. We believe that such a phase-in should be sensitive to the concerns of smaller public companies regarding mandated XBRL-tagged financial statements.

We believe that mandatory implementation of XBRL will involve a number of steps leading to the ultimate goal of requiring public reporting companies to tag their financial statements using XBRL.

Full mandatory implementation may not be possible until all the following preconditions are met:

- Taxonomy development
  - Testing of the XBRL U.S. GAAP Taxonomy is completed. The testing process for the new XBRL U.S. GAAP Taxonomy, which is to determine whether disclosures are complete and relevant in the current market environment, is now underway
  - The final XBRL U.S. GAAP Taxonomy and preparer guide are released following public review and comment
  - Voluntary filers have successfully used the XBRL U.S. GAAP Taxonomy and preparer guide for a period of time
    - Status: On December 5, 2007, XBRL published the draft of XBRL U.S. GAAP Taxonomy and draft preparer guide for public testing and comment. The XBRL U.S. GAAP Taxonomy includes tags for a company's financial statements and footnotes. Public review currently is scheduled to end April 5, 2008, and it is anticipated that the final XBRL U.S. GAAP Taxonomy and preparer guide will be issued in spring 2008.

- Ability of SEC EDGAR to "seamlessly" accept XBRL submissions using the new XBRL U.S. GAAP Taxonomy and other XBRL-tagged data and provide an accurate rendered version of all such tagged information.
  - Status: The SEC has stated that it will use the initial financial statements prepared using the new XBRL U.S. GAAP Taxonomy to help it update EDGAR so that it will be able to "seamlessly accept and render the filings." Currently, the SEC's EDGAR system does not accept financial statements with XBRL tags based on the newly-developed XBRL U.S. GAAP Taxonomy.

We believe that, to achieve the desired acceptance of XBRL, after the XBRL U.S. GAAP Taxonomy precondition is satisfied, on an interim basis XBRL-tagged financial statements should be required to be implemented on a phase-in basis as follows:

- The largest 500 domestic public reporting companies based on unaffiliated market capitalization (public float) should be required to furnish to the SEC, as is the case in the voluntary program today, a document prepared separately from the reporting companies' financial statements that are filed as part of their periodic Exchange Act reports. This document would contain the following:
  - XBRL-tagged face of the financial statements[68]
  - Block-tagged footnotes to the financial statements.[69]

- Domestic large accelerated filers (as defined in SEC rules, which would include the initial 500 domestic public reporting companies) should be added to the category of companies, beginning one year after the start of the first phase, required to furnish XBRL-tagged financial statements to the SEC.

We believe that a phase-in would provide businesses, financial planners, software developers, and investors with the impetus to move forward in building systems based on XBRL. For example, in connection with the mandatory implementation of XBRL, we are aware that, if tagging were mandated for companies, they may use a "bolt-on" solution in-house or use a service provider in the early stages before moving to a broader integrated interactive data approach. This "bolt-on" approach, for many, could be used as a means to begin to climb the learning curve in a cheap, easily managed manner. In this regard, we believe that companies should have the capacity to compare XBRL-tagged and rendered financial statements to avoid errors and the SEC should take steps to assist in that regard. We believe that the SEC should encourage or commission the development of free software to compare rendered and filed statements.

During the phase-in period, the SEC and PCAOB should seek input from companies, investors, and other market participants as to the experience of such persons in preparing and using XBRL-tagged financial statements using the XBRL U.S. GAAP Taxonomy, and related costs. The SEC should consider conducting or commissioning a study of the rate of errors by companies in using the appropriate XBRL tags in comparison to the financial statement items, which should be done only after filers use the final uniform Taxonomy and preparer guidance to tag their financial statements.

As mentioned above, under the phase-in approach, the XBRL-tagged financial statements would still be considered furnished to and not filed with the SEC. As part of the mandatory implementation, we believe that, as is the case in the voluntary program, the

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[68] To allow this first phase, the SEC EDGAR system must permit submissions using the new XBRL U.S. GAAP Taxonomy.

[69] We understand that tagging beyond the face of the financial statements and block-tagging of footnotes, such as granular tagging of footnotes and non-financial data, may require significant effort and would involve a significant number of tags.

SEC should make clear what liability provisions the XBRL-tagged financial statements would be subject to under the federal securities laws.

Finally, at the end of the phase-in period described above, and as promptly as practicable after all the preconditions to full implementation discussed above are met, the SEC should evaluate the results from the phase-in period to determine whether and when to move from furnishing to the SEC to the official filing of XBRL-tagged financial statements with the SEC by domestic large accelerated filers, as well as whether and when to include all other reporting companies, as part of a company's Exchange Act periodic reports.

II.B. Developed Proposals

We would like to make recommendations that increase the certainty that XBRL will be a significant part of the reporting landscape so that preparers, investors, auditors, software developers and regulators make the needed investment in XBRL.

Based on the above considerations, we have developed the following proposal:

Developed Proposal 4.1: ***The SEC should, over the long-term, mandate the filing of XBRL-tagged financial statements after the satisfaction of certain preconditions relating to: (1) successful XBRL U.S. GAAP Taxonomy testing, (2) capacity of reporting companies to file XBRL-tagged financial statements using the new XBRL U.S. GAAP Taxonomy on the SEC's EDGAR system, and (3) the ability of the EDGAR system to provide an accurately rendered version of all such tagged information. The SEC should phase-in XBRL-tagged financial statements as follows:***

- ***The largest 500 domestic public reporting companies based on unaffiliated market capitalization (public float) should be required to furnish to the SEC, as is the case in the voluntary program today, a document prepared separately from the reporting companies' financial statements that are filed as part of their periodic Exchange Act reports. This document would contain the following:***
  - ***XBRL-tagged face of the financial statements[70]***
  - ***Block-tagged footnotes to the financial statements.[71]***

- ***Domestic large accelerated filers (as defined in SEC rules, which would include the initial 500 domestic public reporting companies) should be added to the***

[70] To allow this first phase, the SEC EDGAR system must permit submissions using the new XBRL U.S. GAAP Taxonomy.

[71] We understand that tagging beyond the face of the financial statements and block-tagging of footnotes, such as granular tagging of footnotes and non-financial data, may require significant effort and would involve a significant number of tags.

category of companies, beginning one year after the start of the first phase, required to furnish XBRL-tagged financial statements to the SEC.

- ***Once the preconditions noted above have been satisfied and the second phase-in period has been implemented, the SEC should evaluate whether and when to move from furnishing to the SEC to the official filing of XBRL-tagged financial statements with the SEC for the domestic large accelerated filers, as well as the inclusion of all other reporting companies, as part of a company's Exchange Act periodic reports.***[72]

II.C. Assurance

An important issue related to tagging public company financial statements using XBRL involves whether assurance should be provided by a third party. We understand that among the primary benefits of providing independent assurance of XBRL documents is that financial statement investors could quickly build confidence in interactive data and increase their use of such data. One primary reason for not obtaining such independent assurance of XBRL documents is the concern that the cost and time incurred to obtain such assurance may significantly outweigh the benefits to preparers and investors.

As to assurance, we understand that questions arise as to whether assurance should be provided as to matters such as:

1. The appropriate use of the proper XBRL U.S. GAAP Taxonomy and accurate tagging of financial statements
2. The reasonableness of any company extensions to the XBRL U.S. GAAP Taxonomy
3. The compliance of the XBRL-tagged document (also called the "instance document") with SEC content and format requirements
4. The separate performance of validation checks over footings and inter-checks (for example, whether inventory is reported more than once throughout the document, determine if amounts reported are consistent) of the XBRL instance document
5. Whether the information in the XBRL instance document is the same as the information in the official filed financial statements (applicable under a "bolt-on" state).

We note that there are ways in which companies may, inadvertently or deliberately, create XBRL reports in a manner that will potentially mislead investors. Accordingly, one of our members believes that independent assurance of XBRL documents prepared by management should be provided, as described in items (1) and (5) above (at a minimum), provided that such assurance does not result in a significant increase in costs. This member noted that accounting knowledge and professional judgment would be required in providing that assurance, but believed that the assurance process is relatively simple, should not take a significant amount of time because many steps can be automated, and, therefore, should not be an expensive or time-consuming activity.

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[72] A dissenting vote on developed proposal 4.1 was cast by Peter Wallison.

The concept of obtaining assurance on the correct tags and matching the XBRL rendered documents to the filed statements is predicated on the belief that the incremental monetary and human resource costs to provide the assurance will be very small. Reviewing the tags the first time will involve significant effort, but subsequent reviews may be limited to new or changed tags. Moreover, the costs and benefits of assurance reviews may differ depending on whether companies are using the "bolt-on" rather than the integrated tagging approach. Therefore, our other members believe that it is appropriate to study the assurance process during the phase-in period to assess the actual costs and benefits of assurance that might be provided on the XBRL-tagged financial statements.

The type, timing, and extent of assurance, if any, on a company's XBRL-tagged financial statements and other tagged information required to be furnished to the SEC should take into account the needs of investors, and other market participants, along with the costs to reporting companies. Until a group of reporting companies has been required to furnish to the SEC XBRL-tagged financial statements and notes using the new XBRL U.S. GAAP Taxonomy for a period of time that will allow investors and other market participants to evaluate the reliability of such XBRL-tagged financial statements and notes, it is premature to make concrete suggestions regarding assurance.

Accordingly, our developed proposal does not include any assurance proposal. During the interim phase-in period discussed above, the SEC and PCAOB should seek input from companies, investors, and other market participants as to the type, timing, and extent of desired or needed assurance, if any. This input should include the experience of such persons in preparing and using XBRL-tagged financial statements using the newly-developed XBRL U.S. GAAP Taxonomy, and related costs. Additionally, after public companies are required to tag their financial statements using XBRL, whether in accordance with our proposals or otherwise, the SEC should consider initiating a voluntary pilot program in which companies obtain assurance on their XBRL-tagged financial statements (whether using a "bolt-on" or integrated approach) in order to evaluate fully potential costs and benefits associated with such effort.

III. Improved Corporate Website Use

Background

We have been examining the integral role that technology and corporate websites play in informing the markets and investors about important corporate information and developments, including website disclosure presentations that are under development by software vendors. A valuable element of many of such website presentations is that they present the most important general information about a company on the opening page, with embedded links that enable the reader to drill down to more detail by clicking on the links. In this way, viewers can follow a path into, and thereby obtain increasingly greater details about, the financial statements, a company's strategy and products, its management and corporate governance, and its many other areas in which investors and others may have an interest.

Improving the use of corporate websites can enable shareholders and investors to gather information about a company that is at a level they believe is satisfactory for their purposes, without requiring them to wade through large amounts of written material that may provide a level of detail beyond their particular needs.

Corporate websites offer reporting companies a cost-effective, efficient method to provide information to investors and the market. Encouraging reporting companies to increase their use of their websites, including developing a tiered approach to deliver such corporate information on their websites, would benefit investors of all types, retail and institutional. Enhanced corporate website usage could decrease the complexity of information presentation and would enhance its accessibility. In addition, through coordination by industry participants, uniform best practices on uses of corporate websites could be developed.

The SEC has issued a series of interpretive releases and rules addressing the use of electronic media to deliver or transmit information under the federal securities laws. The SEC issued its last comprehensive interpretive release on the use of electronic media, including corporate websites, in 2000. Since 2000, significant technological advances have increased both the market's demand for more timely corporate disclosure and the ability of investors to capture, process, and disseminate this information. Recognizing this, the SEC has adopted a large number of rules that mandate, permit, or require disclosure of the use of corporate websites to provide important corporate information and developments.

We have been informed, however, that there are continuing concerns about the treatment of website disclosures under the federal securities laws that some have argued may be impeding greater use of corporate websites. These concerns include liability for information presented in a summary format, the treatment of hyperlinked information from within or outside a company's website, the disclosure of non-GAAP measures and required reconciliations to GAAP, and the need for clarification of the public availability of information disclosed on a reporting company website. Consequently, we believe that the SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information. We believe that SEC guidance would encourage further creative use of corporate websites by reporting companies to provide information, including website disclosure formats following industry developed best practice guidelines.

Developed Proposal

Based on the above, we have developed the following proposal:

Developed Proposal 4.2: ***The SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information, which addresses issues such as liability for information presented in a summary format, treatment of hyperlinked information from within or outside a***

company's website, treatment of non-GAAP disclosures and GAAP reconciliations, and clarification of the public availability of information disclosed on a reporting company's website.

Industry participants should coordinate among themselves to develop uniform best practices on uses of corporate websites for delivering corporate information to investors and the market.

IV. Future Considerations

Use of Executive Summaries in Exchange Act Periodic Reports

We have been exploring a requirement to include an executive summary in reporting company annual and quarterly Exchange Act reports (Forms 10-K and 10-Q). We understand that a summary report prepared on a stand-alone basis would not necessarily provide investors with information they need in a desired format. However, an executive summary included in the forepart of an Exchange Act periodic report may provide investors with an important roadmap to the company's disclosures located in the body of such a report. The executive summary in the Exchange Act periodic report would provide summary information, in plain English, in a narrative and perhaps tabular format of the most important information about a reporting company's business, financial condition, and operations. As with the MD&A, the executive summary would use a layered approach that would present information in a manner that emphasizes the most important information about the reporting company and would include cross-references to the location of the fuller discussion in the annual report.

The goal of the executive summary would be to help investors fundamentally understand a company's businesses and activities through a relatively short, plain English presentation. An executive summary in a periodic report may be most useful if it included high-level summaries across a broad range of key components of the annual or quarterly report, rather than detailed discussion of a limited number of variables. The executive summary approach may be an efficient way to provide all investors, including retail investors, with a concise overview of a company, its business, and its financial condition. For the more sophisticated investor, an executive summary may be helpful in presenting the company's unique story, which the sophisticated investor could consider as it engages in a more detailed analysis of the company, its business and financial condition.

The executive summary in a periodic report should be brief, and it might fruitfully build on the overview that the SEC has identified should be in the forepart of the MD&A disclosure. The MD&A overview is expected to "include the most important matters on which a company's executives focus in evaluating the financial condition and operating

performance and provide context."[73] The executive summary should build on the MD&A overview disclosure and include the following:

1. A summary of a company's current financial statements
2. A digest of the company's GAAP and non-GAAP KPIs
3. A summary of key aspects of company performance
4. A summary of business outlook
5. A brief description of the company's business, sales and marketing
6. Page number references to more detailed information contained in the document.

The executive summary would be required to be included in the forepart of a reporting company's annual or quarterly report filed with the SEC or, if a reporting company files its annual report on an integrated basis (the glossy annual report is provided as a wraparound to the filed annual report), the executive summary instead could be included in the forepart of the glossy annual report. If the executive summary was included in the glossy annual report, it would not be considered filed with the SEC.

We will continue to evaluate the concept of requiring an executive summary in a public company's Exchange Act periodic reports such as the annual report on Form 10-K and the quarterly report on Form 10-Q.

Disclosures of KPIs and Other Metrics to Enhance Business Reporting

Enhanced business reporting and KPIs are disclosures about the aspects of a company's business that are the source of its value. The Enhanced Business Reporting Consortium,[74] has stated that the value drivers for a business "can be measured numerically through KPIs or may be qualitative factors such as business opportunities, risks, strategies and plans—all of which permit assessment of the quality, sustainability and variability of its cash flows and earnings." KPIs include supplemental non-GAAP financial reporting disclosures that proponents have stated can improve disclosures by public companies. KPIs are leading indicators of financial results and intangible assets that are not encompassed on a company's balance sheet. Proponents of the use of KPIs note that they are important because they inform judgments about a company's future cash flows – and form the basis for a company's stock price. Managers and boards of directors of companies are said to use KPIs to monitor performance of companies and of management. Market participants and the SEC have identified KPIs as important supplements to GAAP-defined financial measures.

The important issues for us to examine are what types of KPIs should be made available, in what format and at what time, and whether they are clearly and consistently defined

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[73] SEC, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, Securities Act Release No. 33-8350 (December 19, 2003).

[74] The Enhanced Business Reporting Consortium was founded by the AICPA, Grant Thornton LLP, Microsoft Corporation, and PricewaterhouseCoopers in 2005 upon the recommendation of the AICPA Special Committee on Enhanced Business Reporting. The EBRC is an independent, market-driven non-profit collaboration focused on improving the quality, integrity and transparency of information used for decision-making in a cost-effective, time efficient manner.

over time. Currently, companies are disclosing some company-specific KPIs in their periodic reports filed with the SEC or in other public statements. Other people in the market are working on developing industry-specific KPIs in order to improve comparability of companies on an industry basis. We will explore ways to encourage companies to disclose company and industry-specific KPIs. In addition, we will examine who should develop the disclosure standards for defining and measuring KPIs to assure consistency among companies and through time, and whether XBRL should be extended by industry sector to include KPIs and information on intangible assets. Further, we will examine the interplay between the use of non-GAAP measures and KPIs. We also will examine ways in which consistent KPIs can be developed through industry coordination.

Improved Quarterly Press Release Disclosures and Timing

The quarterly press release, being the first corporate communication about the result of the quarter just ended, is viewed as an important corporate communication. This communication often receives more attention than the formal Form 10-Q submission which often occurs a week or two later.

We intend to review the earnings press release for its consistency, understandability and its timeliness. We will consider the consistent provision of income statement, balance sheet and cash flow tables in the quarterly release. We also intend to consider the positioning and prominence of GAAP and non-GAAP figures, GAAP reconciliation, the consistent placement of topics, and clear communication of any changes to accounting methods or key assumptions. Ultimately, we view the goal for an earnings release as a consistent, reliable communication form that all investors can easily navigate.

In addition, we will evaluate the advisability of requiring the issuance of the earnings releases on the same day that the periodic report (e.g., Form 10-Q) is filed, in contrast to the current practice in which the earnings release often is issued before the periodic report is filed. In this regard, we will review a survey of CFA Institute members on a similar proposal, as well as the comments received by the SEC when this idea was put forth in prior SEC rule proposals. We will consider, among other things: (1) the savings in time spent cross-referencing two separate but fairly identical reports separated by a very short period of time, and (2) the elimination of the concern that the two reports may not perfectly match.

We do not intend to deliberate the potential elimination of the issuance of quarterly earnings results. The elimination of quarterly reports would deprive investors of important sources of information about a company's performance. However, we may discuss public projections of next quarter's earnings by company officials, since some believe that this practice is an important underlying source of reporting complexity and other accounting problems. Moreover, as mentioned above, we will focus on efforts to encourage corporate reporting of KPIs and other measures of sustainable business progress over longer periods.

Continued Need for Improvements in the MD&A and Other Public Company Financial Disclosures

Every public company is required to include a MD&A section in its annual and quarterly reports filed with the SEC. The three principal objectives of the MD&A are to:

- Provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management
- Enhance the overall financial disclosure and provide the context within which financial information should be analyzed
- Provide information about the quality of, and potential variability of, a company's earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance.

The SEC has made clear that the quality of the MD&A in public company periodic reports is not as good as it should be. In 2003, the SEC concluded, based in part on the Fortune 500 report issued by Corp Fin, that additional guidance was useful in the following areas:

- The overall presentation of the MD&A
- The focus and content of the MD&A (including materiality, analysis, key performance measures and known material trends and uncertainties)
- Disclosure regarding liquidity and capital resources
- Disclosure regarding critical accounting estimates.

The SEC has stated that the MD&A should not be a recitation of financial statements in narrative form or a series of technical responses to the MD&A requirements.

We understand that investors and other market participants believe that while there has been some improvement in the MD&A disclosures since publication of the SEC's interpretive release in 2003, significant improvement is still needed both in terms of additional disclosures and elimination of what the SEC termed "unnecessary detail or duplicative or uninformative disclosure that obscures material information."

Under the Sarbanes-Oxley Act of 2002, the SEC is generally required to review every public company's filings at least every three years. In that regard, we believe that through the review process, the SEC will gain important insight into whether there has been improvement in the MD&A disclosures and the types of ongoing concerns regarding such disclosures. We will be evaluating whether the SEC should periodically issue a report on common types of comments issued on the MD&A and other financial disclosures, similar to the Fortune 500 report, to provide additional guidance on improving the MD&A in accordance with the SEC's most recent interpretive guidance.[75]

[75] We note that the SEC's comment letters on a reporting company's filings are made publicly available on the SEC website after completion of the SEC's review of such filings. We also note that third parties prepare reports on the MD&A disclosures.

APPENDICES

Index of Appendices

APPENDIX A

SEPARATE STATEMENT OF MR. WALLISON

Introduction

In its meeting on January 11, 2008, the Committee endorsed the use of XBRL for financial reports with this statement: "The Committee believes that the SEC should eventually require all public companies (preparing their financial statements using U.S. GAAP) to tag the financial statements (including footnotes) they are required to file with the SEC as part of their Exchange Act reports using XBRL. The Committee believes such a mandate is necessary in order to encourage the commitment of resources toward the necessary software development for tagging, viewing and reading of XBRL tagged information…" [76]

Yet, despite the value the Committee saw in mandating the use of XBRL by reporting companies, the Committee adopted an extended phase-in that will delay the widespread use of XBRL for financial reporting well into the next decade. I dissented from the Committee's vote—and am filing this separate statement—because I believe the Committee's proposed timetable is (i) based on an erroneous assessment of the potential costs of auditor assurance, (ii) applies restrictions on reporting that will be harmful to XBRL and to users, and (iii) unnecessarily delays the date on which XBRL will be available to investors and analysts.

In the Committee's timetable, the first phase begins with the 500 largest reporting companies. These companies would be required to "file" their regular audited financial statements, as they do today, and at the same time to "furnish" a supplement consisting of the XBRL tags that were applied to the filed statements (for purposes of this memorandum, I will refer to this supplemental XBRL material as the "XBRL financial statements"). In the Committee's recommendation, the XBRL financial statements would include both the facing financials and block-tagged footnotes (block-tagging means that one XBRL tag is applied to the entire footnote, instead of applying individual tags to each of the individual disclosures within the footnote).

The first phase would not begin until certain technical preconditions have been resolved, the most significant of which is the upgrading of the SEC's website to receive XBRL filings. John White, the director of the SEC's Division of Corporation Finance, told the Committee that he did not think the first phase would begin until the fall of 2008. One year after the first phase begins, domestic large accelerated filers (perhaps 1500 additional companies) would be required to "file" their regulator audited financial statements, and "furnish" a set of XBRL financial statements. Some time after the second phase has begun, the SEC is to decide "whether and when to move from furnishing to the official filing of XBRL financial statements for the domestic large accelerated filers, as well as the inclusion of all other reporting companies."

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[76] Draft report, p. 81

The delay

Assuming that the first phase begins in the fall of this year, it seems unlikely that the companies involved will be required to begin with their 10-K reports, which for the most part are due to be filed no later than March 31, 2009. So in reality, the first phase 500 companies will be filing reports and furnishing XBRL financial statements for the quarters ended in 2009 and the 10-K due in March 2010. The second phase will begin late in 2009 (one year after the beginning of the first phase) and will include the financial statements that are due (for most companies) in the first three quarters of 2010 and the 10-K due at the end of the first quarter of 2011. We are already three years from today, and only 2000 or so companies will have been required to prepare XBRL financial statements.

Only after the second phase has begun in late 2009 or early 2010 will the SEC (in the Committee's recommendation) begin to *consider* whether to require *any* companies to file (rather than furnish) their XBRL-tagged financial statements. Since the second phase companies will (in the Committee's recommendation) be permitted to furnish rather than file their XBRL financial statements, that must mean they won't be required to *file* their XBRL financial statements until after their 10-Ks are filed in March 2011. That means no company, large or small, will be required to *file* a 10-K with XBRL financial statements until March of 2012. That's four years from now, and quite a generous phase-in, considering we are talking about only 2000 or so of the largest and most sophisticated companies in the U.S. When the remaining 13,000 reporting companies will be required to file XBRL financial statements under this "mandatory" phase-in is anybody's guess.

The distinction between furnishing and filing is important. Under the Securities Exchange Act of 1934, companies are absolutely liable for false or misleading material filed with the SEC. However, in the case of material that is merely *furnished* to the SEC, liability only attaches if it can be shown that the material was intentionally false or misleading. Accordingly, the Committee seems to have adopted the idea of furnishing rather than filing XBRL financial statements because of its concern about the possible cost of auditor assurance. It seems to have reasoned that, if XBRL financial statements were furnished rather than filed, the reduced liability would permit companies to dispense with auditor assurance entirely, and thus to avoid these potential costs. However, as I will discuss below, the concern about assurance costs is misplaced and ultimately self-defeating. Not only was there no need to require the furnishing of XBRL financial statements, but allowing XBRL financial statements to be furnished rather than filed will severely impair the value of XBRL for investors and analysts and is an important source of what will be an enormous and unnecessary delay in the adoption of XBRL in the United States.

Will auditor assurance as to the accuracy of XBRL-tagged financial statements be costly?

As noted above, the Committee's phase-in recommendation, and its distinction between filing and furnishing XBRL financial statements, were apparently motivated by concern that auditor assurance as to the accuracy of the XBRL tagging will be costly. Some committee members, without any supporting evidence, referred to the process of auditor assurance as potentially as costly as Section 404 of Sarbanes-Oxley—erroneous statements that were picked up in some media reports of the meeting. However, as I will discuss below, concerns about the cost of assurance are unfounded and should not have been a factor in the Committee's deliberations.

Today, most companies that tag their financial statements use the so-called bolt-on method. It is the simplest, although not potentially the least costly, approach to tagging financial statements. In the bolt-on method, financial statements are prepared and audited in the usual way. When the audit is completed, the financial statements are "mapped" to the XBRL taxonomy. This means simply that the various items in the company's financial statement are tagged with the appropriate XBRL tag. The tagging can be done largely automatically, with existing software that reads the financial statement and applies the appropriate tag, or manually through a drag and drop method that also uses available open source (zero cost) software.

Once the items in the financial statements have been tagged, the question arises whether the tags have been correctly selected and applied. It is at this point that the question of assurance becomes significant. It is also important to note that there is no relationship between the audit of the financial statements and the assurance process on the application of the XBRL tags we are discussing here. The audit of the financial statements has been completed when the bolt-on process begins. The assurance process for the XBRL tags does not make the audit in any way more complicated or costly. The only remaining question is whether the tagging, after the audit, has been done properly. For purposes of this memorandum, the key question is what it would cost for the company's auditor, having completed the audit, to determine that the company properly applied the XBRL tags after the audit's completion.

There are only three significant questions that must be answered for the auditors to assure themselves—and to provide assurance to others—as to the accuracy of the tagging:

- Did the company choose the correct XBRL taxonomy (there are several different XBRL taxonomies, because the financial statements of banks, for example, are different from the financial statements of operating companies);

- Did the company properly tag each disclosure in its financial statements? (For example, is the "revenue" item in the financial statements properly mapped to the correct "revenue" tag in XBRL?)

- Did the company add extensions to the tags that were not appropriate in light of the company's business? (Adding extensions to the tags already included in the

XBRL taxonomy, although permissible, could make it difficult to compare one company's financial statements with another's)[77]

To put this in some perspective, one S&P 50 technology company told Subcommittee 4 that its 10-Q report, including the financial statements, block-tagged footnotes, and the MD&A, required only 192 tags. So the assurance process, had it been done for that company by its auditors, would have required that the auditors answer the three questions above for only 192 tags. In the end, the company performed its own assurance, which required only 10 hours of work by one lower level accountant.
Despite the seeming simplicity of the three principal questions, and the relatively small number of tags likely to be involved, is it possible that auditors would have to go through complex steps in order to provide assurance as to the tagging? The answer is no. There is a simple way for assurance to be done, and no reason why a company's auditors would not follow it.

Today, most companies prepare their financial statements in Excel, Word, or some other desktop publishing software; those companies that are furnishing or will furnish XBRL financial statements will use the bolt-on method to add the XBRL tags. Once the tagging has been completed, all these desktop publishing applications can be used to print out a set of financial statements, and when printed out these statements should be an exact replica of the audited human-readable statements. The two financial statements can then be compared either manually, through a visual comparison, or through an automated comparative analysis. If they match, the XBRL tagging must have been accurate—otherwise the XBRL financial statements could not produce an exact replica of the audited human-readable statements. If there are discrepancies, errors in the tagging will be immediately apparent.

Any suggestion that this simple process will or could involve costs remotely like section 404 of Sarbanes-Oxley is thus completely fanciful. A better description of the costs involved in auditor assurance would be one word: trivial.

Is assurance by auditors necessary?

Certainly. There are two reasons. First, without a third-party review, companies will get careless in the rush to complete their XBRL financial reports and file with the SEC. No matter how simple the tagging process, mistakes will be made. Mistakes are especially likely if the tagged financial statements are furnished rather than filed. In that case, companies will believe that they don't have to be particularly careful with the mapping to the XBRL taxonomy, since there will be little likelihood of liability for mere negligence. If, as some have suggested, the SEC will offer some kind of safe harbor for XBRL-tagged financials that are furnished rather than filed, this problem will be compounded;

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[77] In the brief discussion at the Committee meeting on January 11, one member suggested that more financial information was included in XBRL material associated with a financial statement than in the financial statement itself. This is not correct. XBRL does contain any more financial data than the company chooses to disclose in its financial statements.

companies will have little incentive to take the time to get the tagging right, and many incentives to get the tagging wrong if they are hoping to avoid unfavorable comparisons with their peers. Under these circumstances, errors in the tagging—and incorrect information in the XBRL financial statements—will not be an infrequent occurrence; the result will be to raise questions about the value and usefulness of XBRL. In this way, a potentially valuable resource for investors, which could have been introduced without flaws, will be damaged and diminished. And all this because of an unfounded fear that auditor assurance will be costly.

Second, and perhaps even more important, in the absence of any consistent rules for tagging, imposed either by regulation or reporting standards and monitored by auditors, many companies may add extensions to their tags that will make it difficult or impossible to compare their financial results from period to period or with others in their industry. The XBRL taxonomy is a set of standardized categories for typical financial reports. The designers have made efforts to include all the tags that would be necessary to achieve some degree of comparability between companies in the same business. However, companies, on their own, can add extensions to the standard tags in the XBRL taxonomy. In some cases, these extensions may more accurately describe a company's specific unique disclosures (e.g., business segments), but they can also make comparability more difficult.

In the development of XBRL, it was assumed that the tagging process would be reviewed by the company's auditors—not only to assure that the tagging was done properly, but also to impose some period-to-period consistency on the process by which companies choose their tags or add extensions to the standard tags in the XBRL taxonomy. The Committee's proposal to allow XBRL financial statements to be furnished without assurance will invite a chaotic outcome, in which it will be possible for companies to add unnecessary or inappropriate extensions to the XBRL tags. This will impair comparability, one of the principal purposes of XBRL, and substantially reduce XBRL's value to investors and analysts.

Is the furnished vs filed distinction sustainable?

No. The Committee's draft report conceives of the audited human-readable financial statements and the XBRL financial statements as two separate documents. This is certainly true as the bolt-on method is used today. The result is two documents, with the XBRL materials furnished, while the human readable (audited) financial statements are filed. However, if companies follow the Committee's suggestion, they will have to forego the use of a major advance in the formatting of filed documents that will be available to companies around the world in only a few months. This new document format is known as Microformat, and should be available by this coming May. When it is available, it will be usable through the bolt-on method as well as other more efficient and less costly approaches. The technical specifications that will make the Microformat standard possible will be published soon by XBRL International—the umbrella group for the development and worldwide promulgation of XBRL—and this will enable software manufacturers to prepare updated plug-ins, so that existing report-writer and desktop

publishing applications will be able to create Microformat documents. Using the XBRL Microformat standard, it will be possible to *both* print out a human-readable financial statement, and download an XBRL financial statement into a model, from *a single XBRL Microformat document*.

In this case, of course, there can't be a separate filing of the XBRL and human-readable financial statements; nor can the human readable portion be *filed* while the XBRL portion is *furnished*; they will both be included in the same document and rely on the same data. If that data contains an error, both the human readable portion and the XBRL disclosures will reflect that error, because both are derived from the same underlying information. In other words, it will make no sense to apply different liability standards to the human-readable document and to the XBRL tagged disclosures, because both the human-readable audited financial statement and the XBRL financial statement will come out of the same data source.

Under these circumstances, one of two things will happen: either the Committee's distinction between furnishing and filing will be ignored by companies that decide to use the Microformat document, or—more likely—the distinction between filing and furnishing that the Committee (and perhaps the SEC) has offered will induce US companies to forego the Microformat option and continue to use older and less efficient technology for their financial reporting. Accordingly, the Committee's hope that a mandatory timetable for filing financial statements in XBRL format will bring about the adoption of new technology will have been thwarted by the Committee's own (unnecessary) requirements. In addition, the huge efficiency benefits that would come from the creation of a single Microformat document, which can produce both a human-readable statement and be downloaded into a model, will be lost.

Conclusion

Auditor assurance as to the accuracy of tagging is a simple process, and cannot under any imaginable circumstances be costly for companies—large or small—that are required to file XBRL financial statements. There are many ways that assurance can be accomplished through efficient automatic means, but one way that even non-technical people can understand is that the XBRL financial statements can be used to print out a set of human-readable financial statements, which can then be compared visually with the audited statements. If they match, the tagging must have been done correctly. Accordingly, there is no need to distinguish between furnishing and filing XBRL financial statements, and no need for more than a limited SEC inquiry to confirm that the costs are trivial. After that, the SEC can determine how and at what pace it should require companies to file their financial statements in XBRL format.

In my view, therefore, the Committee should eliminate both the distinction between filing and furnishing XBRL financial statements, and the entire phase-in plan contained in its draft report of January 11. Instead, it should—for the reasons stated in the January 11 draft—endorse a requirement that all companies file their financial statements in XBRL Microformat, and leave it to the SEC to determine on what timetable this should occur.

Appendix B

EXAMPLES OF SUBSTANIVE COMPLEXITY

1. Industry-Specific Guidance

1. Below is a list of examples of industry-specific guidance in GAAP. Note that this list does not reflect all industry-specific guidance or all industries subject to its own guidance.

Industry	Sources
Broadcasting Industry	SFAS No. 63, 139; EITF 87-10; SOP 00-2
Banking and Thrift Industries	APB Opinion 23; SFAS No. 72, 91, 104, 109, 114, 115, 147; Technical Bulletin 85-1; FSP 85-24-1; SOPs 90-3, 03-3; EITFs 97-3, 93-1, 92-5, 89-3, 88-25, 88-19, 87-22, 86-21, 85-44, 85-42, 85-41,85-31, 85-24, 85-8, 84-20, 84-9, 84-4, D-Topics D-78, D-57, D-47, D-39, SEC Regulation S-X – Article 9, SEC Industry Guide; AICPA Auditing and Accounting Guide
Cable Television Industry	SFAS No. 51
Computer Software to be Sold, Leased, or Otherwise Marketed	SFAS No. 2, 86
Contractor Accounting: Construction-Type Contracts & Government Contracts	ARB 43, Chapter 11, ARB 45, SFAS No. 111; SOP 81-1
Development Stage Enterprises	Opinion 18; SFAS No. 7, 95, 154; Interpretation 7; SOP 98-5; AICPA Auditing and Accounting Guides
Finance Companies	SFAS No. 91, 111, 115; SOP 01-6; AICPA Auditing and Accounting Guide
Franchising: Accounting by Franchisors	SFAS No. 45, 141
Insurance Industry	SFAS No. 5, 60, 91, 97, 109, 113, 114, 115, 120, 124, 133, 135, 140, 144, 149, 156; Interpretation 40; FSP FAS 97-1; AICPA Auditing and Accounting Guides; EITFs 99-4, 93-6, 92-9; D-Topics D-54, D-35. D-34, SEC Regulation S-X – Article 7, SEC Industry guide
Investment Companies	SFAS No. 102; FSP AAG INV-1; SOPs 94-4-1, 93-1, 93-4, 95-2, 00-3, 01-1; AICPA Auditing and Accounting Guide; D-Topics D-76 D-74, D-11, SEC Regulation S-X – Article 6,
Mortgage Banking Activities	SFAS No. 65, 91, 114, 115, 124, 125, 133, 134, 140, 149, 156; Technical Bulletin 87-3; SOP 97-1, 03-3; EITF 95-5, 90-21, 87-34, 85-13, 84-19, D-Topics D-10, D-4, D-2

Motion Picture Industry	SFAS No. 139, SOP 00-2
Oil and Gas Producing Activities	SFAS No. 19, 25, 69, 95, 109, 131, 143, 144, 145, 153; Interpretation 33, 36, FSP FAS 19-1, 141/142-1, 142-2; AICPA Auditing and Accounting Guide; SEC industry guide, SEC Reg S-X Rule 4-10, SAB Topic 12, FRR Section 406; EITFs 04-6, 04-4, 04-3, 04-2, 90-22
Pension Funds: Accounting and Reporting by Defined Benefit Pension Plans	SFAS No. 35, 75, 102, 110, 135, 149; SOPs 92-6,94-4,94-6,95-1,99-2,99-3, 01-2
Real Estate: Sales & Accounting for Costs and Initial Rental Operations of Real Estate Projects	SFAS No. 13, 34, 66, 67, 91, 98, 114, 140, 144, 152; Interpretation 43; SOPs 75-2, 78-9, 92-1, 97-1, 04-2; AICPA Auditing and Accounting Guide; EITF 06-8, 05-3, 98-8, 97-11, 95-7, 95-6, 94-2, 94-1, 91-10, 91-2, 90-20, 89-14, 88-24, 88-12, 87-9, 86-7, 86-6, 85-27, 84-17, SEC Regulation S-X – Rule 3-14, SEC SAB Topic 5N, 5W
Record and Music Industry	SFAS No. 50
Regulated Operations	SFAS No. 71, 87, 90, 92, 98, 101, 106, 109, 135, 142, 144, Interpretation 40; Technical Bulletin 87-2; EITFs 97-4, 92-7; D Topics D-21, D-5; SAB Topic 10
Title Plant	SFAS No. 61, 144

2. Industry-specific exceptions in GAAP, such as the scope exception for registered investment companies and life insurance entities in FIN 46R, *Consolidation of Variable Interest Entities* and for U.S. savings and loan associations, other "qualified" thrift lenders, and stock life insurance companies in SFAS No. 109, *Accounting for Income Taxes.*

3. Industry practice such as accounting for certain types of inventory at fair value

2. Alternative Accounting Policies

Examples of alternative accounting policies are as follows:

- SFAS No. 87, *Employer's Accounting for Pensions* and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, which permits alternatives for amortizing delayed recognition amounts and for measuring return on plan assets.

- SFAS No. 95, *Statement of Cash Flows,* which permits alternative presentations of the form and content of the statement.

- SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (specifically Q&A 35 of the SFAS 115 Implementation Guide), which indicates that companies are not precluded from classifying securities as trading, even if they have no intention of selling them in the near-term.

- SFAS No. 130, *Reporting Comprehensive Income*, permits a choice in presenting comprehensive income. An entity may present other comprehensive income below the total for net income in a single statement, in a separate statement that begins with net income, or in a statement of changes in equity.

- SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which permits, but does not require, the use of hedge accounting, which, in certain circumstances, may mitigate earnings volatility from marking derivative instruments to market.

- SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits, but does not require, the measurement of certain financial assets and financial liabilities at fair value.

- EITF 88-1, *Determination of Vested Benefit Obligation for a Defined Benefit Plan*, which permits vested benefit obligations to be determined as the actuarial present value of the vested benefits to which the employee is entitled if the employee separates immediately or the actuarial present value of the vested benefits to which the employee is currently entitled but based on the employee's expected date of separation or retirement.

- EITF 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)*, which permits that certain taxes, such as sales, use, and value added taxes, may be presented either on a gross or net basis.

- EITF Topic D-98, *Classification and Measurement of Redeemable Securities,* which permits a choice of methods of accreting to the redemption value.

- FIN 48, *Accounting for Uncertainty in Income Taxes*, which permits an entity to classify interest and penalties as either interest or taxes.

- FSP AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, which prohibits the accrue in advance method, but allows for continued use of one of three other alternatives: direct expense, built-in overhaul, or deferral methods.

- Oil & gas accounting: The two accounting methods followed by oil and gas producers are the successful efforts method and the full cost method. Successful efforts accounting essentially provides for capitalizing only those costs directly related to proved properties; the costs associated with exploratory dry holes are expensed as incurred. Full cost accounting generally provides for capitalizing (within a cost center) all costs incurred in exploring for, acquiring, and developing oil and gas reserves-regardless of whether or not the results of specific costs are successful.

- SAB Topic 5H, *Accounting for Sales of Stock by a Subsidiary*, which permits gains/losses on sales of stock by a subsidiary to be recognized in income or equity.

3. Bright Lines

Examples of bright lines, rules of thumb, and pass/fail models include the following:

A. Bright Lines

- *Lease Accounting*

  Current lease accounting is based on a principle: when a lease transfers substantially all of the benefits and risks of ownership of the property, it should be accounted for as an asset and a corresponding liability by the lessee and the asset is derecognized by the lessor (capital lease); otherwise, rental expense is recognized as amounts become payable (operating lease). However, to apply this principle, SFAS No. 13, *Accounting for Leases*, provides the following bright lines for classifying leases as capital or operating. Meeting any one of these criteria results in capital lease treatment.
  - The lease transfers ownership of the property to the lessee by the end of the lease term.
  - The lease contains a bargain purchase option.
  - The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
  - The present value at the beginning of the lease term of the minimum lease payments, excluding certain items, equals or exceeds 90 percent of the excess of the fair value of the leased property.

- *Consolidation*

  For those entities that are not subject to the FIN 46R model, "the usual condition for a controlling financial interest is ownership of a majority voting interest, and therefore, as a general rule, ownership by one company…of over 50% of the outstanding voting shares of another company is a condition pointing toward consolidation."[78] Further, there is a presumption that an investment of 20% - 50% requires equity method accounting. In addition, the equity method is required for investments in limited partnerships unless the interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies" (SoP 78-9, *Accounting for Investments in Real Estate Ventures*). In this case, practice has used a 3%-5% bright line to apply the "more than minor" provision. This practice has been acknowledged by the SEC staff in EITF Topic No. D-46, *Accounting for Limited Partnership Investments.*

[78] ARB No. 51, *Consolidated Financial Statements*, paragraph 2.

- *Revenue Recognition*

  Bright lines may also be found in revenue recognition literature. One example is SFAS No. 66, *Accounting for Sales of Real Estate*, which provides bright lines for determining the buyer's minimum initial investment requirements for real estate sales.

- *Business Combinations*

  When an SEC registrant undergoes a change in control, the company must reflect the new basis of accounting arising from its acquisition in its stand-alone financial statements (i.e., apply purchase accounting to its own stand-alone financial statements) if the company becomes substantially wholly-owned. "Substantially wholly-owned" is defined such that this push down accounting is prohibited if less than 80% of the company is acquired, permitted if 80% to 95% of the company is acquired, and required if 95% or more of the company is acquired.

  In addition, SFAS No. 141, *Business Combinations*, requires that the purchase price allocation period in a business combination usually not exceed one year from the consummation date.[79]

- *Pension and Other Post-Retirement Employment Benefit Accounting*

  SFAS No. 87, *Employers' Accounting for Pensions,* and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* permit the use of smoothing mechanisms that delay the recognition of the effects of changes in actuarial assumptions and differences between actual results and actuarial assumptions. However, these standards contain a bright line as to when the delayed recognition amounts should be recognized.

- *Hedge Accounting*

  SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, requires that derivative instruments be recognized at fair value, with changes in fair value recognized in income. However, in an effort to mitigate earnings volatility, SFAS No. 133 permits the use of hedge accounting when a derivative is highly effective in achieving offsetting changes in fair value or cash flows attributable to the risk being hedged. GAAP, however, does not define "highly effective." Instead, practice has defined "highly effective" as an offset ratio of 80% to 125%.

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[79] We note SFAS No. 141, *Business Combinations*, has been superseded by a new FASB standard, SFAS No. 141 (revised 2007), *Business Combinations*, which similarly states in paragraph 51, "…the measurement period shall not exceed one year from the acquisition date."

- *Classification*

  Bright lines are also present in classification requirements. For example, SFAS No. 95, *Statement of Cash Flows*, clarifies the definition of "cash equivalents" by stating that "generally, only investments with original maturities of three months or less qualify under that definition" (paragraph 8). Despite use of the word "generally," this bright line is often interpreted stringently.

  In addition, SEC Regulation S-X includes bright lines for separate presentation of amounts that would otherwise be included in lines such as revenue, other current assets and liabilities, and other assets and liabilities.

- *Disclosure*

  Bright lines also exist with respect to the determination of related parties for the purposes of disclosing related party transactions and the identification of segments for the purposes of determining which operating segments require separate presentation.

  Further, SEC Regulation S-X includes a number of bright lines regarding requirements to present stand-alone acquiree financial statements, stand-alone equity method investee financial statements, and pro forma financial information, among others. These bright-lines are based on the results of certain significance tests, or calculations, defined in Regulation S-X. These significance tests compare the acquiree or investee to the registrant in the areas of assets, investments, and income.

B. Rules of Thumb

- *Consolidation Accounting*

  The fall of Enron in late 2001 refocused attention on the effect of bright lines as they relate to consolidation accounting. Enron, and others, took advantage of bright lines related to the consolidation of special purpose entities (SPEs) to avoid reporting assets and liabilities, to defer reporting losses, and/or report gains. At the time, the consolidation of SPEs hinged on an analogy to guidance that required lessees to consolidate SPE lessors that lacked a substantive investment at risk from an unrelated party. "Substantive" was defined as 3%, at a minimum, with the caveat that a greater investment may be necessary in certain facts and circumstances. Despite this caveat, which would suggest the need for judgment, the presence of the 3% bright line gave rise to numerous structured transactions to achieve a specific accounting purpose.

In December 2003, the FASB issued FIN 46R, *Consolidation of Variable Interest Entities*, which superseded the 3% rule. FIN 46R requires consolidation in certain circumstances by the party that holds the majority of the risks and rewards of an entity, rather than equity ownership and voting rights. This model has led some to assert that FIN 46R is a principles-based standard. However, even FIN 46R contains a rule of thumb – a presumption that if equity investment at risk is less than 10% of the entity's total assets, the entity is a variable interest entity subject to the FIN 46R model, with similar caveats that require additional analysis, judgment and consideration.

- *Contingencies*

  SFAS No. 5, *Accounting for Contingencies*, provides an example of rules of thumb in interpretations of GAAP. SFAS No. 5 establishes recognition and disclosure requirements based on the likelihood – remote, possible, probable – that a liability has been incurred. Although GAAP does not define these terms, audit firms have developed rules of thumb for these terms.

C. Pass/fail tests

- SFAS No. 48, *Revenue Recognition When Right of Return Exists*, requires that where a right of return exists, revenue be recognized at the time of sale only if certain criteria, such as the amount of future returns can be reasonably estimated. Otherwise, revenue recognition is deferred until the right expires or the criteria are subsequently met.

- SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* – if critical terms do not match or if documentation does not comply with the rules, then companies are not eligible to apply hedge accounting.

- SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* contains requirements, all of which must be satisfied, to achieve sale accounting for a transfer of financial assets. Otherwise, the transfer is treated as a secured borrowing with a pledge of collateral.

- EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, identifies a number of criteria that must be met in order for an instrument to be classified as an equity instrument. Failure to meet any of these criteria results in classification as a liability, which is marked to market through income. The criteria do not provide for probability assessments or judgments based on the preponderance of evidence.

- SoP 97-2, *Software Revenue Recognition*, related interpretations, and audit firm guidance contain the following pass/fail tests:

- If vendor specific objective evidence (VSOE) does not exist for all of the undelivered elements of a software sales arrangement, the recognition of all revenue from the arrangement must be deferred until sufficient evidence exists, or until all elements have been delivered, unless certain exceptions are met.
- Extended payment terms usually result in a deferral of revenue. Specifically, when extended payment terms are present, a presumption exists that the vendor's fee is not fixed or determinable, due to the possibility that the vendor may provide a refund or concession to a customer. While there are factors to overcome this presumption, interpretive guidance sets the hurdle to overcome this presumption extremely high, generally resulting in the deferral of revenue until payment is due.

Appendix C

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