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Advisory Committee on Improvements to Financial Reporting
c/o Adam Brown, Office of the Chief Accountant
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

**RE: Subcommittee I: Substantive Complexity, December 3, 2007
Meeting**

We are submitting this letter in response to your invitation received by email on October 11, 2007 inviting us to be represented at and submit written materials for consideration in connection with Subcommittee I's meeting to be held on December 3, 2007.

The Center for Audit Quality (CAQ or Center) is an autonomous public policy organization serving investors, public company auditors and the capital markets and is affiliated with the American Institute of Certified Public Accountants (AICPA). The CAQ's mission is to foster confidence in the audit process and to aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Based in Washington, D.C., the CAQ has approximately 800 member firms representing thousands of men and women dedicated to quality public company auditing.

Discussion of definition of complexity

The definition of complexity proposed by the Subcommittee implies that all complexity might be susceptible to remediation. In fact, some complexity emanates from complex transactions and events that, by their nature, are complicated to account for regardless of the approach to the setting of accounting and financial reporting standards.

The Subcommittee should acknowledge two types of complexity: (1) unavoidable complexity, which is a function of the underlying complexity of

the transaction or item being accounted for,¹ and (2) avoidable complexity, which is introduced from other sources and is not a function of the nature of the transaction or item being accounted for.² The Subcommittee then should focus on avoidable complexity, which can be susceptible to remediation. This avoidable complexity increases costs for preparers and auditors, creates arbitrary distinctions that impede effective communication to users, and raises the risk of financial reporting errors.

An alternative definition is suggested as follows:

In the context of the Subcommittee’s deliberations, avoidable complexity in financial reporting (including disclosures) refers to the unnecessary difficulty imposed by a financial reporting regime that creates uncertainty in (1) identifying, interpreting and applying the relevant accounting principles (GAAP) to transactions and events; (2) evaluating the accuracy, relevance and sufficiency of the information necessary to properly apply the relevant GAAP; and (3) using professional judgment when applying the relevant GAAP. Complexity also refers to the difficulty and frustration experienced by users of financial statements in identifying and understanding necessary financial information in an efficient manner.

Avoidable complexity adversely affects all participants in the financial reporting process—preparers, auditors, users, regulators and other stakeholders. For example, avoidable complexity increases the costs of financial reporting by increasing the time and resources necessary to:

- (1) maintain knowledge of overly burdensome detailed requirements in particular areas of accounting;
- (2) perform unnecessarily difficult computations along with associated burdensome record-keeping requirements and develop and maintain the required effective internal controls with respect to those unnecessarily difficult computations and burdensome records;
- (3) promulgate standards and interpretations within the preexisting framework of accounting standards;
- (4) analyze and understand financial statements for purposes of decision making; and

¹ For example, financial instruments include some that are in legal form debt. However, those instruments can include features that make them difficult to analyze and account for. For example, debt instruments can include an optional conversion into equity that is in-the-money at issuance (referred to as a “beneficial conversion feature”). Or a debt instrument might include embedded interest rate or foreign currency derivatives. Likewise, multiple-element product and service agreements may be challenging to analyze, understand and account for.

² Accounting standards themselves can introduce complexity into financial reporting. For example, Financial Accounting Standard No. 13, Accounting for Leases, classifies leases from the lessee’s perspective as either capital leases or operating leases. It also categorizes leases from the lessor’s perspective as sales-type leases, direct financing leases, leveraged leases or operating leases. Each category is replete with its own set of conditions and requirements. Ultimately, however, all leases are financial obligations of the lessee and are assets that have either been sold or not sold by the lessor. The requirements of the applicable accounting standard induce complexity based on its form (e.g., the voluminous body of lease accounting literature) and content (e.g., detailed tests with bright lines for purposes of classification and accounting).

- (5) determine and regulate compliance with generally accepted accounting principles.

Avoidable complexity adds to the volume of guidance that must be considered in preparing financial statements thus increasing the risks and uncertainties associated with failure to identify sources of guidance and potential alternative interpretations; thereby:

- (1) increasing the risk of a material error;
- (2) increasing the risk that auditors, regulators and other third parties will reach different conclusions concerning the application of GAAP thus presenting the risk of restatement and the attendant negative consequences;
- (3) frustrating the use of professional judgment when applying accounting principles;
- (4) increasing the opportunities to structure transactions in ways to achieve accounting results that do not transparently communicate the significant aspects of the transaction, and
- (5) increasing the cost of capital to the extent that financial statements do not transparently reflect the performance and financial condition of the reporting entity.

Pervasive causes of complexity

The current complexity of accounting and financial reporting is the cumulative result of its evolution over the last hundred years, as influenced by the prevailing legal and regulatory environment and the competing needs and desires of all participants in the financial reporting process—preparers, auditors, users, regulators and other stakeholders.

The Subcommittee has identified the following as significant causes of complexity, but acknowledges that this is not an all-inclusive list:

- The increasingly sophisticated nature of business transactions;
- The manner in which financial reporting standards are written and interpreted, including the fear of being “second-guessed;”
- Certain preparers and financial advisors who structure transactions in order to achieve particular financial reporting results;
- The vast number of formal and informal accounting standards, regulations, and interpretations currently in effect.

The first point speaks to unavoidable complexity. Clearly, business transactions have become more complex over time, but this source of complexity is not susceptible to remedial action.

The remaining points are related to causes of avoidable complexity. Pervasive root causes of avoidable complexity will not be susceptible to “quick fixes” or short-term remediation effort because the pervasive root causes will require legislation, extensive changes in the standard setting process and cultural change. These systemic sources of complexity will need to be addressed before there can be any comprehensive resolution of avoidable complexity.

Although you have asked us to focus on causes of complexity prioritized considering the pervasiveness of their impact and the feasibility of reducing their effects in the short term, we will

take this opportunity to also comment on pervasive factors that cannot be resolved in the short term. Some of these might be regarded as environmental factors that exist within the capital markets, while others are related to the standard-setting process that is being addressed by Subcommittee II. Some of these pervasive factors are identified as follows.

Risk of litigation, particularly related to financial statement restatements or unexpected losses. The exposure to legal liability by preparers and auditors fosters a desire for explicit accounting guidance for numerous permutations of potential fact patterns. Since it is assumed that legislation would be required to address this matter, it does not fit within the parameter of remediation in the short run.

SEC staff practices, particularly related to the review of filings and related positions on the application of accounting principles. The SEC Division of Corporation Finance is obligated periodically to review issuers' filings. In its comment letters to issuers, the SEC staff sometimes cites comments concerning an issuer's accounting for certain transactions and may, where the staff deems appropriate, request a restatement. Such restatements sometime involve accounting issues where there is no clear accounting literature and represent informal SEC staff interpretations. When the SEC staff interpretation has not been widely disseminated and is not broadly known and understood, financial reporting diversity may emerge. Further, because informal staff positions may not be documented or captured in published GAAP or SEC publications, changes in SEC staff positions evolve over time as personnel changes occur and as business practices evolve. In addition, issuers and auditors, in order to obtain SEC staff views that might otherwise become known only in the event of a staff review, may consult with the SEC staff on accounting issues on a "pre-filing" basis. These processes give rise to a body of informal and unpublished (and therefore non-public) SEC staff precedent. These SEC staff practices, which are well intentioned efforts on the staff's part to bring guidance in certain areas, are a deeply embedded function of the organization and the existing financial reporting culture. Notwithstanding the good intentions of the staff, we believe that staff guidance should be subject to due process and transparent communication that ensures equal and consistent access to all required accounting guidance.

Impact of self-interest lobbying on the standard-setting process. The process of establishing accounting standards has become increasingly impacted by self-interest lobbying. The involvement of constituencies with agendas that reflect different views of what is a "fair presentation" of financial information has influenced the speed and direction of standards in the past and has become an increasingly significant factor in recent years. In some situations the impact of self-interest lobbying on the standard-setting process has resulted in alternative acceptable approaches for similar transactions or unnecessarily complex provisions (e.g., full cost versus successful efforts methods for oil and gas companies, stock option accounting and accounting for some financial instruments). There is no apparent short term solution to eliminating the self-interest lobbying from standards setting, nor to reversing all of the standard-setting that has been inappropriately complicated by such self-interest considerations, although a long-term commitment to principles based standard setting may reverse certain avoidable complexity over time.

In this regard, this seems to be an opportune point at which to consider the relationship between the activities of the Committee and the movement toward acceptance of International Financial Reporting Standards (IFRS). If, as is currently being considered, IFRS is adopted as the single standard for financial reporting in the U.S. within the next several years, much of the avoidable

complexity of current U.S. GAAP will be supplanted by IFRS. It is naïve to think that IFRS will eliminate all avoidable complexity—in fact it would be a mistake to see IFRS as a panacea—but it will be a move in the right direction. In the interim until IFRS is adopted the question we may be wrestling with here is simply one of –What should we be doing in the “short run” until the adoption of IFRS to address current avoidable complexity?

Although IFRS may solve some of the complexity problem in the mid-term horizon, it is still appropriate now to pursue short-term solutions that will not only provide current relief but may inform future standard setting efforts as we go forward into a new financial reporting paradigm.

Lack of acceptance of differences in professional judgment, including the professional judgment of sophisticated preparers and auditors. Although it is recognized that there are many circumstances in which the language of accounting standards may have been interpreted in an overly broad manner in order to obtain a desired accounting outcome, in most cases today preparers and auditors are acutely aware of the ramifications of a financial reporting failure and are intent on “getting it right”. Real-time judgments of preparers and auditors who acted in ultimate good faith may, nevertheless, be identified as failures to properly apply GAAP as interpreted in hindsight. As a result, preparers and auditors request specific detailed interpretive and other guidance as a precaution against potential accusations of either misapplication of GAAP or, in the most severe situations, of wrongdoing. We understand that the Audit Process and Compliance Subcommittee is considering this issue and the development of a “professional judgments framework” to address the issue. We support that effort as a possible solution, maybe even in the short-term, to this pervasive issue.

Short-term market focus. As described in greater detail later in this document, one of the factors that creates avoidable complexity is the inclusion in accounting standards of provisions that are intended to “smooth” accounting effects to reduce volatility of reported financial performance. These smoothing provisions have been incorporated into accounting standards, in great part, because of the market pressure to avoid earnings volatility and the rewards that accrue to entities that report predictable and stable financial performance. This cultural aspect of the capital markets system, when coupled with the inordinate focus of investors on short-term earnings (i.e., quarterly) and the need to meet management’s earnings guidance for quarterly periods, exacerbates other sources of avoidable complexity (i.e., impact of self-interest lobbying on the standard setting process and financial engineering). In addition, others, such as the U.S. Chamber of Commerce, have expressed concern that this short-term focus actually drives businesses to make short-term business decisions that are detrimental to these businesses over the long term. Recent work by the Committee for Economic Development and the Aspen Institute reinforce concerns about “short-termism” consistent with the concerns of the U.S. Chamber.

We understand that this Committee has not been assembled to specifically address this issue. However, a marketplace that continues to focus on the short-term attainment of management’s earnings guidance and penalizes entities for earnings volatility (even though volatility is an economic reality) will continue to put pressure on the most pervasive factors affecting avoidable complexity.

Financial Engineering. Accounting is not an absolute science, it is a convention to quantify and report economic activities. Business activities are not conducted without regard to their accounting

consequences. Instead, many transactions are structured to meet, or arbitrage, the applicable accounting standards. Such financial engineering is inevitable. In addition, standards setting and interpretive activities tend to address perceived abuses in such financially engineered transactions. This results in a vicious cycle whereby future transactions are engineered to satisfy and exploit the revised accounting guidance. The cycle of financial engineering, not all of which is nefarious, induces complexity in financial reporting which is likely to be best addressed through long-term commitment to principles based standard setting.

Discussion specific causes of complexity and actions to address

In your invitation to participate in the December 3 meeting you have asked us to identify three to five specific causes of complexity prioritized considering the pervasiveness of their impact and the feasibility of reducing effects in the short term. As indicated above, there are certain pervasive causes that cannot be resolved in the short term. However, we believe there are certain causes of avoidable complexity that can be addressed in the short term. The following describes these causes and specific actions the Subcommittee should consider in developing its recommendations.

Standards that are written to anticipate specific details of transactions. The manner in which standards are written contributes to complexity. Accounting standards should be articulated in plain English, with a clear explanation as to the underlying principle, the reason why each detailed requirement is important to analyzing the basic principle, and appropriate examples to illustrate the link between the detailed requirements and the principle. Writing accounting standards in this manner should enable diligent CPA preparers and auditors to apply most standards without extensive assistance from subject matter experts. Unfortunately, this is not the case with many recently issued standards. Interpretation 46R and Statement 133 are often cited by corporate accountants and field audit partners as nearly impossible to comply with absent assistance of subject matter experts.

As an example, FIN 46R, Consolidation of Variable Interest Entities, is a standard which in published form is 45 single spaced pages of text and spends two introductory pages simply identifying the entities that are in and out of the scope of the standard. International Financial Reporting Standards addresses the same consolidation area in Standing Interpretations Committee Interpretation 12 (SIC 12) which is six pages, with less text per page, in its entirety. The major reason for the difference in the two standards is the degree of detail encompassed by FIN 46R as compared to the much simpler principles based approach of SIC 12.

A suggested short-term approach to address partial remediation (full remediation is not a short-term project) would be to identify some or all of those IFRS standards and interpretations that are currently in existence that the FASB could substitute for current detailed U.S. GAAP standards without changing the basic principled requirements and propose accelerated incorporation of those selected principles into U.S. GAAP.

In addition, the FASB should solicit input on the 5-10 areas in GAAP that currently contain the most avoidable complexity, and undertake short-term projects to fix those areas. These short-term projects should be undertaken even if the Board is currently working on a longer-term project in the same area, as long-term projects can take 5+ years to complete. A perfect example of an unnecessarily burdensome and costly requirement is the APIC pool under FAS 123R. Companies

have built entire systems to track the information necessary to compute the APIC pool, yet this information is not decision-making useful or relevant. Similar concerns have been raised by constituents with respect to the burdensome computations that must be performed to comply with Statement 123R's prohibition on recording an income tax benefit to capital until it is "realized."

Beyond these focused efforts, there should be a comprehensive approach to remediate existing standards. The FASB's current codification project should help to simplify the organization of existing authoritative literature. However, it will initially codify existing standards using their original language. A second phase of the project could involve a critical review and revision of the codification to achieve plain English expression.

As discussed above, these actions would need to be considered in light of any comprehensive plan to evolve the U.S. financial reporting environment to IFRS.

Desire for predictable earnings that are susceptible to management influence. Preparers generally resist changes to accounting standards that might make reported earnings more volatile. Preparers desire, and users have come to reward, predictable earnings on a quarterly basis. As a result, preparers have generally resisted fair value measurement principles and have requested and received various accommodations to reduce related earnings volatility (e.g., smoothing pension gains and losses by amortizing amounts outside a defined corridor; reporting changes in the fair value of available for sale securities in other comprehensive income; deferral of gains and losses related to derivatives that hedge anticipated transactions; a two-step approach to recognizing an impairment of a long-lived asset). In turn, these accommodations have led the FASB and the SEC to adopt provisions to curtail potential abuses of these accommodations. The accommodations and related anti-abuse provisions induce complexity.

A disaggregated statement of performance will be useful to achieving the Subcommittee's objectives. If the income statement were disaggregated into various categories, such that certain sources of volatility were separately displayed from an entity's core operations, standard setters would likely be under less pressure to grant the exceptions and safe harbors that contribute so significantly to complexity. We recommend that FASB and IASB accelerate and revise as necessary phase B of their joint project on financial statement presentation to allow users to better understand how past operating, financing and other activities caused an entity's financial position to change, the components of those changes, and the ability to use that understanding to better assess the amounts, timing and uncertainty of future cash flows.

An essential aspect of reducing complexity that is integral to this topic is the imperative to reexamine and change as necessary all standards that include scope exceptions, bright-lines, smoothing provisions that artificially mask real economic volatility and other features that enable preparers to structure transactions and their recognition in ways that impede transparent understanding of current changes and events. We believe that the expanded use of fair value for financial instruments in the preparation of financial statements will enhance both short and long term transparency with respect to the financial condition and results of operations of business enterprises.

Patchwork standards setting As acknowledged in the July draft of the Discussion Paper by Chairman Pozen, there have been multiple sources of authoritative accounting guidance (e.g., FASB, EITF, AcSEC, AICPA, SEC, and SEC staff). The intricate hierarchy, historical context and unclear

relationship of this guidance make it difficult to apply, either directly or by analogy. Further, the scope of various standards is defined in a way that creates inconsistencies in practice, as well as uncertainty as to the standards applicability. This patchwork approach induces complexity in financial reporting.

One aspect of complexity is the level of effort necessary to identify all of the sources of financial reporting requirements applicable to a set of financial statements. Subcommittee II on Standard Setting is addressing this issue but there is substantial overlap between the considerations of that Subcommittee and Subcommittee I as it relates to complexity. The FASB's project to codify GAAP in a single reference source will be a great step forward. As an immediate improvement to this area of complexity, we recommend that the SEC adopt rule revisions to eliminate certain unnecessary financial reporting rules and clarify the status of its informally promulgated guidance.

While it is appropriate for the SEC to promulgate rules that identify what financial statements should be filed and for what entities and for what periods, other requirements in Regulation S-X and other SEC guidance seem unnecessary and/or redundant. For example, with the exception of Rule 4-08(g) that requires summarized information for certain significant investees and Rule 4-10 that sets out requirements with respect to oil and gas producing activities, all of Article 4 of Regulation S-X seems unnecessary.

Patchwork standards setting creates ambiguity and inconsistency within the body of GAAP. This cause of complexity is closely related to the first area identified in the Subcommittee's Report for Discussion at the November 2, 2007 Full Committee Meeting under the Scope of Work Plan regarding the elimination of "industry specific guidance." We concur that "industry specific guidance" is a source of complexity for all of the reasons identified in the Subcommittee's report. We further agree that GAAP based on activities rather than industries is preferable (particularly when the activities of a particular industry are not economically dissimilar from the activities engaged in by other industries). However, industry specific guidance frequently addresses areas of accounting, such as revenue recognition criteria, in which there is no promulgated GAAP that is activities based. We would support elimination of industry specific guidance once "activities based" standards have been developed. In this regard we note that FASB added a revenue recognition project to its agenda in 2002 and the current project plan calls for a preliminary views document to be issued in the first quarter of 2008. Given the pace of the project, it is assumed that the finalization of standard setting on revenue recognition will not occur in the short term. Therefore any attempt to eliminate all industry specific guidance is not feasible in the short term without leaving a void where activities based guidance does not exist. However, given the possible movement of U.S. public companies to IFRS, we urge the SEC, the FASB and other participants in the financial reporting process to begin a comprehensive reconsideration of the existing body of industry specific guidance within U.S. GAAP, with a view to eliminating guidance that conflicts with the conceptual framework or general accounting standards and identifying areas that can be eliminated once "activities based" standards have been developed. Even with the adoption of IFRS, industry specific guidance within U.S. GAAP still could influence decisions under IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors.



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We welcome the opportunity to offer this submission in advance of the December 3 subcommittee session exploring "Substantive Complexity." It represents the observations of members of the CAQ, but not the views of any specific firm or individual -- including the two members of the Center's governing board appointed to serve on the Advisory Committee: Grant Thornton, LLP Executive Partner and Chief Executive Officer Ed Nusbaum and Deloitte Touche Tohmatsu Chief Executive Officer Jim Quigley.

Sincerely,

A handwritten signature in black ink, appearing to read "Sam Ranzilla".

Sam Ranzilla
Chairman, Professional Practice Executive Committee
Center for Audit Quality