

**ADVISORY COMMITTEE  
ON IMPROVEMENTS TO  
FINANCIAL REPORTING**

**DRAFT DECISION MEMO**

**January 11, 2008**

Advisory Committee  
on Improvements to Financial Reporting

Draft Decision Memo

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## CHAPTER 1: INTRODUCTION

In July 2007, the United States Securities and Exchange Commission (SEC or Commission) chartered the Advisory Committee on Improvements to Financial Reporting (Committee). The Committee's objective is to examine the U.S. financial reporting system to identify ways to improve it. To accomplish its objective, the Committee is focusing on ways to make information presented by U.S. public companies more useful and understandable for investors, while reducing the complexity of such information to investors, preparers, and financial professionals.

The Committee believes that financial reporting should provide information that aids users in making investment, credit, and similar resource allocation decisions.<sup>1</sup> However, some argue that over time, financial reporting has become a burdensome compliance exercise with decreasing relevance to users. This effect can be attributed, in part, to i) the fact that evolution of new business strategies and financing techniques stretches the limits of what the traditional reporting framework can effectively convey, and ii) an overly litigious culture that, arguably, results in financial reporting designed as much to protect against liability as to inform investors. As a result, the Committee believes 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 this context. The Committee proposes to apply the following definition of complexity during its deliberations on financial reporting.

### **Definition of Complexity**

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

- (1) users 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 (GAAP) and communicate the economic substance of a transaction or event and the overall financial position and results of a company, and
- (3) other constituents to audit, analyze, and regulate a company's financial reporting.

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<sup>1</sup> 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*, issued on 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."

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

### **Causes of Complexity**

Significant causes of complexity include (not an all-inclusive list):

- (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:
  - Opposing points of view, such as lobbying on both sides of a debate, that are taken into account when developing standards. Most importantly, attempts by public companies to smooth amounts that are not smooth in their underlying economics contribute to complexity.
  - 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 over time;
  - 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 challenging for particular fact patterns.
- (5) Audit and regulatory systems that challenge the use of professional judgment – The risk of litigation and of being “second-guessed” creates significant consequences for failing to communicate unbiased financial information appropriately.
- (6) Educational shortcomings – Undergraduate and graduate education in accounting have traditionally emphasized the mechanics of double-entry bookkeeping, which favors the use of detailed rules rather than the full understanding of relevant

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principles. The same approach is evident in the CPA 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 a user, 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 users 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.

The Committee observes 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. The Committee's focus is on avoidable complexity, with an emphasis on improvements that are feasible in the near term.

More specifically, the Committee's charter identifies the following areas of inquiry to make financial reporting more useful and understandable for investors:

- The current approach to setting financial accounting and reporting standards, including (a) the principles-based vs. rules-based standards, (b) the inclusion within standards of exceptions, bright lines, and safe harbors, and (c) 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; and
- 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.

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Upon conclusion of the Committee's work (and possibly at interim dates), the Committee will provide written recommendations to the Chairman of the SEC on how to improve the financial reporting system in the U.S. These recommendations may cover many aspects of the financial reporting system for the SEC to consider, including recommendations that involve the Financial Accounting Standards Board (FASB), the Public Company Accounting Oversight Board (PCAOB), and other appropriate organizations.

In order to maximize the benefits of this Committee, it intends to issue a limited number of recommendations. The Committee intends for the recommendations to be doable; that is, they will be adoptable by administrative action and not require legislation. The Committee also intends for the recommendations to be focused. It acknowledges that financial reporting involves myriad aspects and does not expect to address every issue. Instead, the Committee seeks to focus on those areas where there is a consensus that a problem exists and where it is feasible to find ways to implement improvements. As part of this focus, the Committee has limited its deliberations to matters involving SEC registrants. While financial reporting matters and, more specifically, GAAP, similarly apply to private entities, including nonprofit organizations, the Committee has taken this approach in its role as an advisory committee to the SEC.

The Committee has also focused its scope as it relates to international matters. The Committee notes that the SEC recently adopted rules to no longer require a U.S. GAAP reconciliation for foreign private issuers reporting under IFRS as issued by the 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. The Committee has proceeded on two premises: (1) that, despite any potential actions by the Commission to permit IFRS reporting by domestic issuers, U.S. 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 U.S. GAAP and IFRS will continue. As a result, the Committee believes it is productive to make recommendations on improving U.S. GAAP, as well as the related processes at the FASB, the PCAOB and the SEC. At the same time, the Committee will point out how its recommendations can be coordinated with the work of the IASB and the development of IFRS, with the objective of promoting convergence.

To facilitate the forming of these recommendations, the Committee has created subcommittees which report to the Committee for full discussion and deliberation. The subcommittees are listed below.

- I. Substantive Complexity
- II. Standard-Setting Process
- III. Audit Process and Compliance
- IV. Delivering Financial Information

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Matters related to international coordination will be addressed, as appropriate, as part of the Committee's deliberations beginning in 2008.

The purpose of this draft decision memo is to present the Committee's developed proposals, conceptual approaches, and future considerations based on the Committee's work to date. Developed proposals are sufficiently formed so that, shortly after approval at this meeting, they will be formally submitted to the Commission. Conceptual approaches differ from developed proposals in that conceptual approaches represent the Committee's initial discussions and leanings on a particular subject, but still require significant additional deliberation prior to formalization into a developed proposal. Future considerations represent areas where deliberation is still pending.

Questions for the Committee:

- 1.1) Do you agree with the proposed definition of complexity? Are there any revisions you would recommend?
- 1.2) Have the most significant causes of complexity been identified? If not, what other causes should be considered? How might they be addressed?

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## CHAPTER 2: SUBSTANTIVE COMPLEXITY

### I. Scope

This chapter of the Draft Decision Memo focuses on avoidable substantive complexity that currently exists in GAAP. Subsequent chapters address financial reporting improvements through changes in the standard-setting, audit, regulatory, and information delivery processes.

The Committee has identified the following manifestations of avoidable substantive complexity:

- Exceptions to general principles in the form of:
  - Industry-specific guidance
  - Alternative accounting policies
  - Scope exceptions other than industry-specific guidance
  - Competing models
- Bright lines
- Mixed attribute model and the appropriate use of fair value

Exceptions to general principles create complexity because they deviate from established standards that were developed in due process. In effect, users 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.

Bright lines are problematic because they create superficial borders along a continuous spectrum of transactions. However, the more fundamental issue is the fact that financial reporting standards require drastically different accounting treatments on either side of a bright line.

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 users. While some advocate using fair value for the entire balance sheet as a solution, there are difficult questions about relevance and reliability with which to contend, 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 the mixed attribute model and more meaningful grouping of

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individual line items on the financial statements. The Committee intends to pursue these topics in 2008. Lastly, while deliberations have been conducted primarily in the context of U.S. GAAP, the Committee believes that its analyses and proposals are similarly applicable under IFRS.

Questions for the Committee:

2.1) Do you agree with the scope in the area of substantive complexity? Are there any areas you would recommend adding, removing or revising?

## **II. Exceptions to General Principles**

### **II.A. Industry-Specific Guidance**

#### **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 (e.g., Statement of Position 97-2, *Software Revenue Recognition*), and (3) industry practices not specifically addressed or based in GAAP. Industries covered by this guidance include, but are not limited to, insurance, utilities, oil and gas, mining, cable television companies, financial institutions, real estate, casinos, investment companies, broadcasters, and the film industry. Refer to Appendix B for specific examples.

Industry-specific guidance can be categorized in one of the following:

- Guidance that is consistent with generalized GAAP – for example, certain guidance in AICPA Accounting and Auditing Guides is issued to assist preparers in interpreting and applying existing, generalized GAAP.
- Guidance that 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 up-front 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, SEC Staff Accounting Bulletin (SAB) 104, *Revenue Recognition*, (as codified in SAB Topic 13) which provides more generalized guidance, indicates this practice is inappropriate unless it is specifically prescribed elsewhere (such as SFAS No. 51). Therefore, similar activities like up-front fees for gym memberships are not afforded equal treatment.
- Guidance for which no generalized GAAP exists – for example, SoP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type*

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*Contracts*, discusses revenue and cost recognition in areas such as the construction industry, due to the absence of a general revenue recognition standard.

Industry-specific guidance has developed for a number of reasons, including:

- A lack of general standards in certain areas of GAAP (e.g., a single comprehensive revenue recognition standard).
- The activities of multiple standard-setting organizations.
- A desire by some to customize accounting standards for allegedly “special” transactions and user needs (each industry believes it is unique).
- A desire by some, including preparers, users, standard-setters, and regulators, to enhance uniformity throughout an industry.
- A tendency by industries to develop their own practices in the absence of applicable authoritative literature, coupled with the documentation of such practices by standard-setting organizations (i.e., documentation of what preparers are doing rather than consideration of what they should be doing).

Industry-specific guidance contributes to avoidable complexity in the following ways:<sup>2</sup>

- Incomparable and inconsistent reporting, such as:
  - Reduced comparability across industries, if conflicting accounting models are used for transactions with similar or identical economic substance.
  - Improper analogizing to industry standards in order to achieve desired results or to require a more conservative accounting treatments (e.g., by auditors).
  - Diverse conclusions as to whether similar companies are within the scope of specific guidance. This issue becomes problematic for diversified companies who may be involved in a number of different industries with conflicting industry-specific guidance.
- Unnecessarily increasing the volume of accounting literature. This volume, in turn, may result in:
  - Increased costs of implementing accounting literature.
  - Increased costs in maintaining accounting literature and more expansive standard-setting.
  - Increased costs of training accountants and retaining industry experts.

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<sup>2</sup> As noted previously in the 2003 SEC report to Congress on the adoption in the United States of a principles-based accounting system:

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 standards 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.

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- Complexity for users in understanding the variety of accounting and disclosure.
- Hindering more wide-spread use of XBRL, as it increases the number of different data tags that need to be created, maintained, and properly used in information delivery.

On the other hand, industry-specific guidance may alleviate complexity in the following ways:

- By allowing industry reporting to better meet the specific user needs in that industry.
- By enhancing comparability across entities within an industry.
- By depicting important differences in the economics of an industry, particularly where application of a generalized principle may not result in accounting that is representationally faithful to a transaction's economic substance.
- By developing guidance where it is otherwise lacking in generalized GAAP.
- By simplifying or reducing the amount of guidance a preparer in an industry would need to consider, even though it might increase complexity across industries generally.
- By addressing prevalent industry issues quickly. Specifically, industry-specific guidance may be easier to issue on an accelerated basis due to its narrower audience than that of generalized GAAP.

The Committee acknowledges that industry-specific guidance has merit in certain situations, such as (1) where it interprets, rather than contradicts, principles and (2) where the activities in question are legitimately different (which are expected to be rare). However, the Committee believes that decreasing the amount of industry-specific guidance would reduce avoidable complexity. In this regard, to the extent that such guidance interprets principles (i.e., relates to implementation), it should not be included in GAAP. 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.

### **Developed Proposals**

Based on the above considerations, the Committee has developed the following proposals:

#### **Developed Proposal 2.1: *GAAP should be based on activities, rather than industries.***

- *Any new projects undertaken separately by the FASB or IASB should be scoped on the basis of activities rather than industries.*
- *Any new joint projects between the FASB and the IASB should be scoped on the basis of activities rather than industries, and should include the elimination*

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***of existing industry-specific guidance in relevant areas as a specific objective of those projects, unless in rare circumstances, retaining such guidance can be justified.***

As described above, one cause of industry-specific guidance is the absence of on-point, generalized GAAP. As generalized GAAP is developed, the Committee believes that industry-specific guidance should be eliminated.

Nevertheless, the Committee acknowledges that cost/benefit considerations might justify industry-specific guidance in limited situations. For example, cost/benefit considerations may 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 FASB should work with the relevant industries to identify long-term ways to phase out industry-specific guidance with as little cost as possible. In addition, the FASB should provide sufficient time to allow companies to transition to generalized GAAP, to help reduce the costs of transition.

From an international perspective, the Committee notes that IFRS currently contains less industry-specific guidance than U.S. GAAP and that such guidance focuses more on the nature of the activity (e.g., agriculture, insurance contracts, exploration and evaluation of mineral resources). Nonetheless, the IASB should be mindful of this recommendation, if adopted, as it continues to develop a more comprehensive body of standards. Further, if this recommendation is adopted, the IASB should also ensure that any future industry-specific (i.e., activity-based) guidance is limited to activities whose economics are legitimately different from other business activities. Otherwise, the Committee believes specialized accounting for only certain subsets of similar activities will create avoidable complexity.

- ***In conjunction with its current codification effort, the FASB should add a project to its agenda to remove or minimize existing industry-specific guidance that conflicts with generalized GAAP prior to achieving full convergence.***

The Committee has observed the FASB's codification project can be used to divide existing industry-specific guidance into one of three categories:

- a. Guidance that conflicts with generalized GAAP
- b. Guidance for which there is no generalized GAAP on point
- c. Guidance which duplicates generalized GAAP

The Committee believes efforts to reduce existing industry-specific guidance should focus primarily on Category a. above. Further, as new, generalized guidance is issued, including that which is issued through the convergence process, the SEC staff should eliminate its industry-specific guidance in those areas, if any. Please refer to chapter 3 of

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this report for the relative priority on the FASB's agenda of this proposal to reduce specialized accounting.

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

Questions for the Committee:

- 2.2) Do you agree with the presumption of basing GAAP on activities, rather than industries? If not, please explain why you believe industry-scoped accounting standards are preferable.
- 2.3) Do you agree with the developed proposal to minimize future industry-specific guidance? What revisions, if any, would you suggest?
- 2.4) Do you agree that industry-specific guidance which conflicts with generalized GAAP (category a. guidance above) is best addressed by adding a separate project to retroactively address such conflicts? Or are constituents better served by addressing conflicts in the context of new standard-setting projects?

**II.B. Alternative Accounting Policies**

**Background**

Alternative accounting policies refer to optionality in GAAP. The following discussion addresses formally-promulgated options in GAAP (i.e., it does not address choices available to preparers at more of a practice / implementation level<sup>3</sup>). Examples of optionality in GAAP include, but are not limited to: (a) the indirect vs. the direct method of presenting operating cash flows on the statement of cash flows, (b) the application of hedge accounting,<sup>4</sup> (c) the option to measure certain financial assets and liabilities at fair value, (d) the immediate or delayed recognition of gains/losses associated with defined benefit pension and other post-retirement employee benefit plans, and (e) the successful

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<sup>3</sup>An example is determining the depreciation method that most accurately reflects the pattern of consumption in a particular fact pattern—straight-line, double-declining balance, etc.

<sup>4</sup>The Committee has 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, the Committee generally feels 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 pro rata approach versus an all or nothing approach). The Committee is also aware of the FASB's derivatives project in this area and is generally supportive of its progress.

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efforts or full cost accounting method followed by oil and gas producers. Refer to Appendix B for additional examples.

Alternative accounting policies arise for a number of reasons, including:

- Circumstances where the pros and cons of competing policies may be balanced and thus, not result in a single, clearly preferable approach.
- Political pressure results in standard-setters providing for a preferred and an alternative accounting method.
- Administrative convenience of the preparer (e.g., cost-benefit considerations).
- A portrayal of differences in management intent.

Alternative accounting policies contribute to avoidable complexity in the following ways:

- Incomparable and inconsistent reporting, such as:
  - Reduced comparability across companies, if identical activities are accounted for differently.
  - Accounting that is less reflective of economic substance, to the extent that alternative accounting policies are based on political pressure.
  - Differences in accounting policies selected by preparers to achieve the most favorable accounting treatment.
- Unnecessarily increasing the volume of accounting literature to address each alternative accounting policy.

On the other hand, alternative accounting policies may alleviate complexity in the following ways:

- 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.
- By developing alternatives more quickly than a final “perfect” standard and minimizing the effect of other unacceptable practices. In other words, alternative accounting policies may function as a short-term fix on the road to ideal accounting (evolution of accounting theory).

While the Committee believes that the elimination of alternative accounting policies would reduce avoidable complexity, it acknowledges that such alternatives may have merit in certain circumstances. Accordingly, any recommendation should allow for these circumstances, which are articulated below.

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## **Management Intent**

Some alternative accounting policies are based on management intent.<sup>5</sup> Management intent is a present assertion about management's plans for future courses of action.<sup>6</sup>

The Committee has 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 a 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 of the use of management intent 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 while management intent is subjective and could change, this characteristic is no different than 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, the Committee has determined that accounting based on management intent is too dependent on facts and circumstances to feasibly address within the Committee's timeframe.

## **Developed Proposals**

Based on the above considerations, the Committee has developed the following proposals with respect to alternative accounting policies, other than those arising from management intent:

***Developed Proposal 2.2: GAAP should be based on a presumption that formally promulgated alternative accounting policies should not exist.***

- ***Any new projects undertaken separately by the FASB or IASB should not provide additional optionality, unless in rare circumstances, it can be justified.***

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<sup>5</sup> For example, SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities*, allows management to classify certain debt instruments as either held-to-maturity, available-for-sale, or as 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.

<sup>6</sup> The definition of management intent and certain other concepts in the discussion of alternative accounting policies are adapted from a 1994 FASB Special Report: *Future Events: A Conceptual Study of Their Significance for Recognition and Measurement*.

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- ***Any new joint projects between the FASB and the IASB should not provide additional optionality, but 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.***

Possible justifications for retaining alternative accounting policies include:

- Multiple accounting alternatives exist that are consistent with the conceptual framework, and none are determined to provide significantly better information to investors than others.
- An alternative or interim treatment can be developed more quickly than a final “perfect” standard, minimizing the effect of other unacceptable practices (evolution of accounting theory).

In the event one or both of the justifications above applies, the Committee believes that:

- The provision of alternative accounting principles should be coupled with a long-term plan to eliminate the alternative(s) through the use of sunset provisions.
- The effect of applying the alternative policy not selected by the company should be clearly and succinctly presented, (i.e., either through financial statement presentation or footnote disclosure).

From an international perspective, the Committee notes that IFRS currently permits numerous alternative accounting policies. While the Committee acknowledges the IASB’s efforts in reducing some of these alternative treatments, the Committee nonetheless believes that the IASB, like the FASB, should be mindful of this recommendation, if adopted, and seek to eliminate alternatives as part of its standard-setting projects.

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

Questions for the Committee:

- 2.5) Do you agree with the presumption of minimizing alternative accounting policies? If not, please describe the circumstances in which they are preferable.
- 2.6) Do you agree with the developed proposal to reduce alternative accounting policies in future standard-setting activity? What revisions, if any, would you suggest?

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- 2.7) Do you agree that reducing existing alternative accounting policies is best addressed in the context of future standard-setting? Or, are constituents better served by adding a separate project to standard setters' agendas to retroactively address such alternatives?
- 2.8) Do you believe that the issue of accounting based on management intent is so dependent of facts and circumstances that it is not feasible to address within the Committee's duration?

## **II.C. Scope Exceptions in GAAP Other Than Industry-Specific Guidance**<sup>7</sup>

### **Background**

Examples of scope exceptions in GAAP other than industry-specific guidance include:

- 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*.
- Business scope exception to the applicability of FIN 46R, *Consolidation of Variable Interest Entities*, subject to certain criteria.
- Application of SFAS No. 157, *Fair Value Measurements*, to share-based payment transactions.

Scope exceptions contribute to complexity because they result in different accounting for similar activities, require detailed analysis 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, the evolution of accounting theory discussed above, and the magnitude of change that would result from eliminating or reducing them.

### **Future Considerations**

The Committee intends to deliberate this issue subsequent to the January 11, 2008 meeting.

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<sup>7</sup> The Committee has limited its focus to scope exceptions, while acknowledging there are other types of exceptions in GAAP. This limited approach was considered appropriate in light of the Committee's short duration.

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Questions to be Subsequently Considered by the Committee:

- 2.9) Do you believe that scope exceptions in GAAP other than industry-specific guidance contribute to complexity? Why or why not?
- 2.10) How significant would potential unintended consequences of eliminating scope exceptions be? Consider for example, the normal purchases and normal sales exception in SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
- 2.11) In what circumstances can scope exceptions be justified? Conceptually, how stringent should a presumption against scope exceptions be, if at all?
- 2.12) Please describe examples where scope exceptions result in accounting that is more representationally faithful than applying the related general principle.

**II.D. Competing Models**

**Background**

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 models for asset impairment testing such as inventory, goodwill, and deferred tax assets, etc.
  - 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

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- 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 are 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.
  - Different models for revenue recognition in the absence of a general principle.
  - Different models for derecognition of a pension or other post-retirement benefit obligation liability via settlement, curtailment, and negative plan amendments compared to derecognition of other liabilities on the basis of legal extinguishment.

Competing models contribute to 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, the evolution of accounting theory discussed above, and the magnitude of change that would result from eliminating or reducing them.

### **Future Considerations**

In future deliberations, the Committee intends to explore the role of competing models in increasing avoidable complexity. The Committee will also explore, as discussed in chapter 3, the relationship between these competing models and the FASB’s conceptual framework.

#### **Questions to be Subsequently Considered by the Committee:**

- 2.13) Do you believe that competing models in GAAP contribute to complexity? Why or why not?
- 2.14) What would the consequences be of a recommendation to minimize such competing models?
- 2.15) In what circumstances can different models for similar types of transactions or events be justified?
- 2.16) Please describe examples where different models are necessary to result in representationally faithful accounting.

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### **III. Bright Lines**

#### **Background**

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

Quantified thresholds include hard-and-fast cutoffs, rules-of-thumb, and presumptions 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 two quantitative tests,<sup>8</sup> where a mere 1% difference in the results of the quantitative tests leads to very different accounting.

Pass/fail tests are similar to quantitative thresholds in that they result in recognition on an all-or-nothing basis. However, 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 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.

Refer to Appendix B for additional examples.

Bright lines arise for a number of reasons, including:

- An effort to drive comparability across companies.
- Convenience for preparers, auditors, and regulators because they reduce the amount of effort that would otherwise be required in applying judgment (i.e., the effort in understanding a transaction, debating potential accounting applications, and documenting that judgment) and the belief that they reduce the chance of being second-guessed.
- 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.

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<sup>8</sup> Specifically, SFAS No. 13, *Accounting for Leases*, requires that leases be classified as capital leases and recognized on the lessee's balance sheet where (a) the lease term is greater than or equal to 75% of the estimated economic life of the leased property or (b) 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.

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- Efforts to curb abuse. For example, some argue that sole reliance on judgment may result in aggressive accounting practices, such as revenue recognition where sufficient supporting evidence may not exist.

Bright lines contribute to avoidable complexity in the following ways:

- Incomparable and inconsistent reporting, such as:
  - Accounting that is not representationally faithful to the economic substance of the arrangement, particularly due to the all-or-nothing recognition described above.
  - 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.
  - Structuring opportunities to achieve a specific financial reporting result. For example, whole industries have been developed to create structures to work around lease and hedge accounting rules.
- Unnecessarily increasing the volume of accounting literature. This volume:
  - May result from standard-setters and regulators attempting to curb abuse from structured transactions that result from bright lines by developing additional guidance.
  - May require additional expertise to account for certain transactions, which increases the cost of accounting and the risk of restatement.

On the other hand, bright lines may alleviate complexity in the following ways:

- By reducing judgment, which may limit aggressive accounting policies.
- By enhancing perceived uniformity across companies.
- By providing convenience, as discussed above.
- By limiting 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 more timely. 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 (evolution of accounting theory).

### **Conceptual Approach**

The Committee is still in the process of debating when, if at all, bright lines are justified in accounting literature. The Committee notes that even if standard-setters limit the issuance of bright lines, audit firms and other parties would likely continue to create non-authoritative guidance. As such, any 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 the Committee's consideration of a professional judgment framework, as discussed in chapter 4, and the

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Committee's consideration of interpretive implementation guidance and transition to and design of new standards, as discussed in chapter 3.

In addition, the Committee will continue to explore the following conceptual approaches:

**Conceptual Approach 2.A:** *The Committee is 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:*

- *Pro rata accounting - The Committee uses the term “pro rata accounting” to refer to proportional recognition, rather than the current all-or-nothing recognition approach. For example, consider a lease where 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 pro rata accounting, a lessee would recognize an asset for its right to use the machine (rather than an asset for a proportion of the asset) at approximately \$40<sup>9</sup> 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 – The Committee recognizes that pro rata accounting is not universally applicable. In those cases, enhanced disclosure may be more appropriate. The Committee has yet to define the possible scope of pro rata accounting and/or enhanced disclosure, but it may extend to areas such as leases, consolidation policy and off-balance sheet activity.*
- *Rules-of-thumb coupled with additional considerations – The Committee uses the phrase “rules-of-thumb coupled with additional considerations” to refer to a less stringent use of bright lines, where professional judgment factors into an accounting analysis. The Committee will also consider rules-of-thumb coupled with additional considerations in situations where pro rata accounting may not be applicable.*

**Conceptual Approach 2.B:** *Further, the Committee is considering a recommendation related to the education of students, as well as to the continuing education of users, preparers and auditors, etc. The recommendation would encourage understanding of the economic substance and business purposes of transactions, in contrast to mechanical compliance with rules without sufficient context.*

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<sup>9</sup> 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 pro rata accounting may be an asset's estimated useful life, future cash flows or the share of a company's liabilities in a structured investment vehicle. The Committee is planning additional deliberations in this regard.

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Question to be Subsequently Considered by the Committee:

- 2.17) Some have argued that bright lines in U.S. GAAP result in structuring opportunities. Are structuring opportunities under U.S. GAAP more prevalent than under IFRS, which provides more generalized guidance in certain areas (e.g., lease accounting, revenue recognition, new basis / push down accounting, consolidations)?
- 2.18) Under what circumstances would requirements based on each of the following be appropriate:
- Bright lines
  - Pro rata accounting
  - Additional disclosure
  - Rules-of-thumb coupled with professional judgment?
- 2.19) What other alternatives should be considered as viable alternatives to bright lines?

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

##### **Background**

As previously noted, the mixed attribute model is one where 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 the recognition of some adjustments to carrying amounts in earnings and others in comprehensive income.

Examples of accounting standards that result in mixed attribute measurement include:

- SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which 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*, which requires certain investments to be recognized at fair value and others at amortized cost.

As discussed earlier, some have advocated mandatory and comprehensive use of fair value as a solution to the complexities arising from the mixed attribute model. However, the use of fair value contributes to avoidable complexity in the following ways:

- Incomparable and inconsistent reporting, due to:

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- The lack of a single set of generally accepted valuation standards for financial reporting purposes.
- Inputs to fair value models that are not easily verifiable. Consequently, according to some, there is too much subjectivity in the development of fair values, which significantly impacts the auditability of the numbers.
- Significant variance in the quality, skill, and reports of valuation specialists. Preparers have limited ability to assess this variety. Further, there is no mechanism to ensure ongoing quality, training, and oversight of valuation specialists.
- Financial reporting standards that are difficult to apply in practice
  - Some preparers' knowledge of valuation methodology is limited, requiring the use of valuation specialists, which results in additional expense.
  - Auditors often also require valuation specialists to support the audit. Some view the need for these valuation specialists as a duplication of efforts, at the expense of the preparer.
  - The effort and elapsed time required to implement and maintain mark-to-model fair values would be significant whether performed internally or by valuation specialists.
- Unnecessarily increasing the volume of accounting literature:
  - Some entities question whether investors are averse to volatility or hold management responsible for unfavorable results created by volatility from markets that management does not control. Consequently, entities have demanded exceptions from the use of fair value in financial reporting, resisted the use of fair value in financial reporting, and/or entered into transactions that they otherwise would not have undertaken to limit earnings volatility. These actions have resulted in an unnecessary increase in the volume of accounting literature.
- Impact on audit and regulatory systems
  - There is concern about second guessing by auditors, regulators, and courts in light of the many judgments and imprecision involved with fair value estimates.
- Making information delivery more difficult
  - Some users may not understand the uncertainty associated with measurements based on fair value (i.e., that they are merely estimates and in most instances lack precision), including the quality of unrealized gains and losses arising from changes in fair value.
  - Some question whether the use of fair value may lead to counter-intuitive results. For example, an entity that opts to fair value its debt may recognize a gain when its credit rating declines.
  - Some question whether the use of fair value for held to maturity investments is meaningful.
  - Preparers view disclosure of some of the inputs to the assumptions as sensitive and competitively harmful.

On the other hand, the use of fair value may alleviate complexity in the following ways:

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- By providing users with the same information as management, to the extent management makes decisions based on fair value.
- By improving the relevance of information in many cases, as historical cost is not meaningful for certain items.
- By enhancing consistency, such as:
  - 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.
  - Mitigating the need for detailed application guidance explaining which instruments must be recorded at fair value.
  - Helping to 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.
- By eliminating certain 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 the Management Intent section 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.

The Committee acknowledges the view that a complete transition to fair value would alleviate avoidable complexity resulting from the mixed attribute model. However, the Committee also recognizes 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 its work.

In light of its limited duration, the Committee recognizes it may not independently develop a comprehensive measurement framework, but plans to provide input to the FASB's project in this area (discussed below). As a result, the Committee believes that recommendations requiring a consistent measurement framework and better communication of measurement attributes would more feasibly alleviate 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.

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## **Conceptual Approach**

Based on the above, the Committee will continue to explore the following conceptual approaches:

***Conceptual Approach 2.C: Measurement framework*** – While the Committee may not be able to comprehensively address when fair value is the appropriate measurement attribute, it understands that the FASB’s conceptual framework project includes a measurement phase. The Committee intends to study this project further and is considering recommending 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 2.D: Moratorium*** – Due to implementation complexities, as noted above, the Committee is considering whether the FASB should refrain from issuing new standards and interpretations that require the expanded use of fair value in areas where it is not already required, until completion of the measurement framework. The Committee will also consider whether exceptions to this moratorium should be provided to facilitate necessary improvements to certain complex standards, such as SFAS No. 133 and SFAS No. 140.

***Conceptual Approach 2.E: Grouping in Financial Statement Presentation*** – The Committee believes 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. The Committee believes that such a grouping would be more understandable to users, particularly as it would more clearly delineate the nature of changes in income (e.g., volatility, changes in estimate, business activity, etc.). This presentation might also help users assess the degree to which management controls each income item.

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

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*The Committee intends to study this project further and consider whether it would address the Committee’s leanings in this area and sufficiently facilitate users’ understanding of fair value.*

**Conceptual Approach 2.F: Additional Disclosure** – *The Committee has identified potential areas for additional disclosure to more effectively signal to users the level of uncertainty associated with fair value measurements in financial statements. Specifically, the Committee notes 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 vs. that of the entire market.*

*The Committee acknowledges uncertainty also exists in other measurement attributes, such as historic cost, which may warrant similar disclosure.*

**Conceptual Approach 2.G: Disclosure Framework** – *The Committee seeks to balance additional disclosure requirements, including, if any, those under conceptual approach 2.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 users 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 Committee’s efforts and future standard-setting activity, the Committee is considering recommending (1) that the FASB 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 piece-meal 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 standards are issued.*

Questions for Subsequent Consideration by the Committee:

- 2.20) Do you agree with the intention to refrain from determining the specific circumstances in which fair value should be used and, instead, primarily focus on ways to better communicate measurement attributes and the use of fair value to investors?

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- 2.21) Do you agree with the intention to refrain from addressing implementation issues, such as whether there is a need for valuation-related standard-setting and regulation?
- 2.22) What key elements should a measurement framework incorporate?
- How much weight should be placed on relevance vs. reliability?
  - Should a measurement framework prescribe a consistent measurement attribute for similar activities or similar assets / liabilities?
- 2.23) Do you agree with a full or partial moratorium on future standards that require or permit the use of fair value until the measurement framework is complete? If you do not believe a full moratorium is appropriate, what is the proper degree, if any?
- 2.24) Do you believe grouped financial statement presentation will be effective in reducing concerns about the mixed attribute model and the use of fair value? If not, what alternatives should be considered?
- 2.25) Do you believe the additional disclosure described above, as applicable, should be applied to other measurement attributes, such as historic cost? Why or why not?
- 2.26) Do you believe disclosure of company-specific projections used in fair value estimates, such as future revenue streams, are appropriate? How do concerns about the company harming its competitive position in the market factor in?
- 2.27) What additional disclosures would you recommend to address concerns and confusion due to the current mixed attribute model?
- 2.28) What specific improvements would you recommend to the FASB's current piece-meal approach to establishing disclosure requirements? To the extent that you believe a disclosure framework would improve the FASB's current approach, what key elements should such a framework incorporate?
- 2.29) Do you agree with the view that the SEC should develop a process to regularly evaluate and, as appropriate, update its disclosure requirements as new standards are issued? Should the Committee identify specific indicators as to when SEC disclosure requirements are justified in addition to or in lieu of FASB disclosure requirements? If so, what indicators would you recommend?

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## CHAPTER 3: STANDARD-SETTING PROCESS

### I. Scope

This chapter examines the standard-setting process in the U.S. Specifically, this chapter addresses the following areas:

- Increased user/investor involvement
- FAF governance
- Standard-setting process improvements
- Interpretive implementation guidance
- Transition to and design of new standards

The Committee notes that certain of its proposals in this area 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 this chapter will acknowledge, where applicable.

International Considerations: As further described in chapter 1, the Committee plans to address international considerations in its scope, but has deferred most of the discussion in this regard until later in 2008. The Committee believes that many of its developed proposals and conceptual approaches regarding the standard-setting process would be applicable to the international standard-setting process, with certain required modifications. Therefore, the Committee plans to revisit international considerations so that its recommendations will consider the fact that both U.S. GAAP and IFRS are currently accepted in the U.S.

#### Question for the Committee:

- 3.1) Do you agree with the scope as it relates to the standard-setting process and the process of issuing interpretive implementation guidance in the U.S.? Are there any areas you would recommend adding, removing or revising?

### II. Overview

A robust standard-setting process is the foundation of a transparent, efficient system of financial reporting, which allows providers of capital to effectively monitor their investments. Although the U.S. approach to financial reporting has been quite effective in achieving these overarching objectives, U.S. GAAP has evolved over many years, with some of the basic principles becoming obfuscated by detailed rules, bright lines, exceptions and regulations, which reduce the transparency and usefulness of the resulting financial reporting. The structuring of accounting-motivated transactions partially gave rise to the creation of such detailed rules, many of which were intended to close loop

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holes and prevent abusive application of the accounting standards. This motivation was often driven by the desire of issuers to achieve certain earnings results or by the promises of sponsors that undertaking certain transactions would result in a particular accounting result.

Historically, interpretative implementation guidance has proliferated from a variety of sources and, intentionally or not, become an additional source of U.S. GAAP that may add to the complexity in the financial reporting system, especially when questions exist about its authoritative nature or conflicts exist between interpretations. In addition, the fear of having reasonable, good-faith judgments second-guessed sometimes causes preparers, auditors and regulators to engage in what could be termed “defensive accounting and auditing,” which is the practice of requesting more rules and interpretive implementation guidance. Such defensive accounting and auditing may further exacerbate the problem.

The Committee sets forth a number of proposals that serve to underscore the pre-eminence of the user perspective in designing and administering a well-designed and effective system of financial reporting. Using this perspective as a keystone will serve as a bulwark against the self-interest of those constituencies with a vested stake in a particular accounting treatment. In its creation, the founders of our modern accounting system equated maintaining balance amongst the different stakeholders as an important means of maintaining fairness in the system. The Committee believes that the system will be best served by recognizing the interests of users/investors as the foremost stakeholder when competing interests are unable to be completely aligned.

This chapter presents a number of developed proposals and conceptual approaches intended to alleviate some of the aforementioned concerns. In general, the design of the U.S. financial reporting system and the roles that each participant plays are largely appropriate, but the behavior of each participant has been impacted by the current regulatory and legal environment. Therefore, the Committee believes that small improvements to the existing standard-setting process and the process of issuing interpretive implementation guidance in the U.S. may significantly influence behaviors and help financial reporting to better serve the needs of investors and other users.

Also, many aspects of the proposals and approaches are already in place or occur informally in practice, but some of these existing processes may not be fully effective or well-understood. Therefore, the proposals and approaches are meant to both increase the effectiveness of these processes, as well as their transparency, which will be critical if the behavior of participants in the financial reporting process is to be influenced. However, the interdependence of the Committee’s proposals and approaches will necessitate many, if not all, of them being implemented if the perceived benefits are to be fully realized.

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### **III. Increased User/Investor Involvement**

As discussed more fully below, the Committee has developed the following proposal relating to increased user/investor involvement in the standard-setting and regulatory processes:

***Developed Proposal 3.1: Additional user/investor involvement in the standard-setting process is central to improving financial reporting. Only if user/investor perspectives are properly considered will the output of the financial reporting process meet the needs of those for which it is primarily intended to serve. The SEC should formally encourage the following improvements:***

- ***Additional users/investors should be added to the FAF to ensure that additional views of users/investors are brought to bear in the governance process.***
- ***Experienced users/investors who regularly use financial statements to make investment decisions should be better represented on both the FASB Board and its staff to ensure that the standard-setting process and the process of issuing interpretive implementation guidance better consider the usefulness of the resulting information.***
- ***As more fully described in developed proposal 3.4, consideration of user/investor views in the agenda-setting process should be increased as part of a formal Agenda Advisory Group.***
- ***The FASB should solicit comments from a diverse panel of experienced users/investors on whether the proposed changes improve the current approach prior to exposing new accounting standards or interpretive implementation guidance for public comment.***
- ***The FASB should consider other measures designed to ensure that the user/investor perspective is given preeminence when balancing the perspectives of constituents during the standard-setting process.***

**Background:** User/investor involvement is critical to maintaining effective financial reporting, yet the intricacy of certain accounting matters and the overly complex nature of the current debate often make it difficult to attract meaningful user/investor participation in the standard-setting process. The Committee believes that it is important to reiterate the preeminence of the user/investor perspective in the design and implementation of financial reporting. By properly emphasizing the perspective of users/investors, all stakeholders will benefit from a system that allocates capital more efficiently. This perspective can be best promoted by taking a number of basic steps in improving user representation throughout the standard-setting process.

The Committee acknowledges the significant effort by the FASB over the past few years to increase user/investor involvement in standard-setting. Specifically, the FASB has leveraged a number of existing advisory groups and has established a number of

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additional advisory groups to assist with bringing additional user/investor perspectives, including:

- The Financial Accounting Standards Advisory Council (FASAC), which has more than 30 members, including several users of financial information.
- In 2003, the FASB established the User Advisory Council (UAC), which includes representatives from individual and institutional investors, equity and debt analysts, lenders and credit rating agencies.
- In 2005, the FASB established the Investor Task Force (ITC), which is comprised of representatives of many of the nation's largest institutional asset managers.
- In 2007, the FASB established the Investors Technical Advisory Committee (ITAC) to increase participation in the standard-setting process by users/investors with strong accounting backgrounds.
- The FASB also creates resource groups to assist either formally or informally on major projects, which often includes some user/investor representation.
- The EITF includes two user/investor representatives.

Because users/investors often lack a monolithic viewpoint and have differing perspectives, the FASB may receive mixed messages with respect to a particular issue. Therefore, developed proposal 3.1 is intended to provide the SEC and FASB with more focused, efficient, and timely user/investor feedback.

FAF and FASB: Increasing the direct involvement of users/investors on the FAF and FASB could have a significant benefit of bringing these perspectives to the forefront of the accounting standard-setting process and the process of issuing interpretive implementation guidance. Therefore, the Committee recommends that the composition of the FAF Trustees include more user/investor perspectives and that the FASB Board include no less than one, but perhaps more, users/investors who regularly use third party financial statements.

The proposal complements the FAF's proposed changes to the size and composition of the FAF and the FASB in its recent *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB*. The Committee is supportive of the FAF's proposed changes, but believes that the composition of the FASB Board should be clarified to require (1) a preparer, an auditor, and at least one user/investor who regularly uses third party financial statements, and (2) that the remaining at-large Board members should be selected based upon the most qualified individuals that have a breadth of experiences to ensure that the perspectives of users/investors are represented. The Committee recognizes that a potential move towards five FASB Board members from seven would increase the influence of users/investors on the Board, and believes that such a result is fully consistent with a desire to continue to build and maintain a robust system of financial reporting.

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Some participants in the financial reporting community believe that a focus on user/investor needs could be enhanced in the standard-setting process without the need to actually increase user/investor involvement on the FAF and FASB. However, the Committee concluded, on balance, that increased direct, active user/investor involvement would (1) improve the transparency of and familiarity with the standard-setting process within the user/investor community, and (2) better align the traditionally distinct fields of accounting and finance over time. Additional representation on both the FAF and the FASB will not only bring additional user/investor perspectives from those individual representatives, but also from the users/investors they choose to consult.

There may be opportunities to increase user/investor involvement on the FASB staff, as well. The FASB has a few individuals on staff whose principal professional experience is in the investing community, and the FASB has had a fellowship program in place for many years, but the auditor and preparer communities most frequently provide resources to fill these roles. The FASB has approached user/investor groups about the possibility of sponsoring fellows, but thus far has had limited success. The Committee believes that users/investors should work together to identify and advance qualified resources to join the FASB staff in fellowship positions to help improve the balance of user/investor perspectives during standard-setting.

User/Investor Fatal-Flaw Review: To further increase the direct feedback from users/investors during the standard-setting process, the FASB should add a requirement to perform a scalable user/investor fatal-flaw review designed to assess perceived benefits to users/investors prior to the issuance of Exposure Drafts. The following attributes should be considered by the FASB when designing such a fatal-flaw review:

- Seek formal comments from a diverse panel of users/investors (e.g., buy-side analysts, sell-side analysts, rating agencies), all of which should have strong interests in the outcome.
- The goal should be to ask users/investors to consider the accounting guidance through the eyes of the typical, informed investor to determine whether the new information provided would be decision useful (whether it will provide better information than what is currently available), as well as meet the benefit portion of the cost-benefit constraint.
- Perform the user/investor fatal flaw review prior to exposing the accounting guidance for public comment so the results may be factored into the cost-benefit analysis.
- The Board should be willing to revisit or even discontinue a standard-setting project based upon the feedback received.

Many aspects of the proposed user/investor fatal-flaw review may already occur on an informal basis, but the Committee notes that the benefits of such user/investor fatal-flaw reviews would best be achieved if other users/investors who may not be asked to participate in the process are at least aware of their existence. Therefore, the Committee

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proposes that the process be formalized, required for all new standards, and made more transparent.

Such a fatal flaw review would be analogous to obtaining experienced user/investor input that the reporting regime would improve as a result of the implementation of the proposed standard. The Committee does not envision that this requirement would supplant any of the other important, systematic user/investor feedback that the FASB receives throughout the standard-setting process.

Other FASB Measures: The FASB does have comments in its mission statement, precepts, and objectives that speak to importance of users of financial information, and its precepts provide for balancing perspectives. However, the Committee believes that the FASB Board and staff should consider the user/investor perspective to be preeminent in their decision-making processes, given that (1) users/investors are the primary beneficiaries of financial reporting, and (2) such a focus ultimately benefits all stakeholders by making the capital markets more efficient and robust.

Although it is important to strike an appropriate balance between the perspectives of users/investors, preparers and auditors, the objective in the near-term should be to improve that balance by increasing consideration of the users/investors' perspectives in the standard-setting process. Therefore, the FASB should consider other measures, which may include clarifying the Board's mission statement, stated objectives and precepts, designed to ensure that the user/investor perspective is given preeminence when balancing the perspectives of constituents during the standard-setting process. In addition, all Board members and staff should attempt to routinely evaluate accounting standards and interpretive implementation guidance from the perspective of a typical, informed user/investor. This is not to say that other perspectives should be ignored; rather, consideration of the needs of the recipients of the financial information itself should be paramount.

Question for the Committee:

3.2) Do you agree with developed proposal 3.1? What revisions, if any, would you recommend?

#### **IV. FAF Governance**

As discussed more fully below, the Committee has developed the following proposal relating to FAF governance:

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***Developed Proposal 3.2: The SEC should assist the FAF in enhancing its governance over the FASB, as follows:***

- ***By formally supporting the FAF’s proposals outlined in the “Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB”, particularly the decision to end the constituent-based approach to selecting trustees.***
- ***By encouraging the FAF to amend the FASB’s mission statement, stated objectives or precepts to highlight that an additional goal should be to minimize avoidable complexity.***
- ***By encouraging the FAF to consider developing performance metrics to monitor the FASB’s compliance against its stated goals over time.***

Proposed FAF Governance Changes: The Committee is supportive of the FAF’s recent *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB*, as outlined below.

*FAF Size and Composition:*

- 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. The Committee is supportive of these proposals, particularly the decision to end the constituent-based approach to selecting trustees, but believes that additional representation from users/investors as further described in developed proposal 3.1 should be considered.

*FAF Oversight:*

- The FAF proposes to increase its active oversight of the FASB. Many of the developed proposals and conceptual approaches in this chapter provide meaningful input and support regarding how and in what areas such oversight should be strengthened.
- As noted below, the FAF should also consider establishing performance metrics to measure and track the efficiency and effectiveness of the standard-setting process over time.
- As noted in developed proposal 3.3, establishing a formal Agenda Advisory Group will help reduce influence on the Board from any single group of constituents and maintain its independence.

*FASB Board Size and Composition:*

- The FAF proposes to change the size and composition of the FASB. The Committee is supportive of such changes, but as noted in developed proposal 3.1, the composition of the FASB Board should be clarified to require (1) a preparer, an auditor and at least one experienced user/investor who regularly uses third party financial statements. The Committee recognizes that a potential move towards five board members from seven would increase the influence of users/investors on the Board, but believes such a result is appropriate.

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*FASB Voting:*

- The FAF proposes to maintain the FASB's current majority voting requirement. The Committee is supportive of this proposal to further promote the timeliness of the standard-setting process and the process of issuing interpretive implementation guidance.

*Leadership of the Agenda by the FASB Chairman:*

- The FAF proposes to give the FASB Chairman control over the FASB's agenda. The Committee understands that the FAF intends for the FASB Chairman to continue to consult with other Board members, the SEC and user/investor advisory groups when making agenda decisions. The proposed formal Agenda Advisory Group in developed proposal 3.3 could help serve that function. An Agenda Advisory Group, which would include more formal user/investor involvement than currently exists, would help shield the FASB from influence by any single group of constituents, while at the same time injecting transparency and accountability into the agenda-setting process for all involved parties. Given that the proposed Agenda Advisory Group would not have a binding impact on the FASB's agenda, instilling more decision-making authority in the FASB Chairman, combined with a *requirement* to consult, would be a positive step towards increasing the efficiency of the Board.
- However, the Committee would like to highlight that an essential aspect of effective management of the agenda would be to remove items based upon other priorities. This would allow the Board to be more effective in the projects it perceives as the most beneficial.

Objectives: The FASB's mission statement, objectives and precepts recognize that efficient functioning of the capital markets relies upon credible, concise, transparent and understandable financial information. They also discuss the importance of the usefulness of financial information, keeping standards current, considering areas of deficiency that need improvement, international convergence, understandability of the results, neutrality, weighing constituent views, satisfying the cost-benefit constraint, minimizing disruption by providing reasonable effective dates and transition provisions, following an open due process, and reviewing the effects of past decisions in a timely fashion to interpret, amend or replace standards, when necessary.

The Committee believes that minimizing avoidable complexity (see definition in chapter 1) should be an additional explicit goal to which the FASB aspires. Amending its mission statement, stated objectives or precepts may cause Board members and the FASB staff to give explicit and transparent consideration during the standard-setting process to whether or not there are less complex alternatives to the positions being evaluated during the standard-setting process.

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Performance Metrics: The FAF should also consider establishing performance metrics to measure and track the efficiency and effectiveness of the standard-setting process over time. The Committee does not believe that such metrics would have a detrimental impact on the Board's independence; rather, they should be designed to introduce accountability into the standard-setting process. Properly established performance metrics may also assist the FAF in balancing the competing requirements in standard-setting of timeliness and conceptual merit. The FAF might consider developing performance metrics designed to assess timeliness and compliance with stated goals in the FASB's mission statement, objectives and precepts as a starting point.

Question for the Committee:

3.3) Do you agree with developed proposal 3.2? What revisions, if any, would you recommend?

## **V. Standard-Setting Process Improvements**

As discussed more fully below, the Committee has developed the following proposal and conceptual approach relating to improving the standard-setting process:

***Developed Proposal 3.3: The SEC should formally encourage the FASB to further refine its standard-setting process by performing the following:***

- ***Creating a formal Agenda Advisory Group that includes strong representation from users/investors, the SEC and the PCAOB to actively recommend priorities for managing standard-setting priorities in the U.S.***
- ***Improving its procedures for field testing, field visits and cost-benefit analyses, by:***
  - ***Requiring that scalable field tests, field visits, and cost-benefit analyses be performed for new standards that would better leverage resources in the preparer, auditor, and user/investor communities; and***
  - ***Implementing certain cost-benefit process improvements.***

Formal Agenda Advisory Group: A formal Agenda Advisory Group that includes strong representation from users/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 the agenda of the standard-setting system, while at the same time maintaining an appropriate focus on user/investor needs. The Committee acknowledges that many of the consultations that would occur formally under its proposal occur informally today at the SEC and FASB; however, the Committee believes that formalizing the process and making it more transparent would assist in managing competing priorities and increase accountability.

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The primary goals of the formal Agenda Advisory Group would be to (1) help the standard-setting process become more nimble, (2) help the standard-setter keep its authoritative guidance as useful as possible by keeping it current, and (3) reduce the need for the SEC or other parties to issue interpretive implementation guidance. By identifying emerging issues and building consensus about which group is best positioned to deal with them (e.g., the FASB, EITF or SEC) and in what form, the formal Agenda Advisory Group would give immediate input about how best to prioritize near-term versus long-term priorities.

The Committee does not believe that input currently received regarding the FASB's agenda should be lessened in any way; rather, it should be centralized, more formal and more timely. A formal Agenda Advisory Group should be implemented contemporaneously with a reconsideration by the Board of whether to consolidate some of the *input* currently received regarding its agenda from other sources that may otherwise overlap with the Agenda Advisory Group. By involving representatives from its other advisory groups in the Agenda Advisory Group, the FASB Chairman may be able to centralize user/investor perspectives, thereby increasing their prominence during the agenda setting process (see developed proposal 3.1).

The proposed formal Agenda Advisory Group would be different from the role already performed by FASAC. Timely involvement would be critical to proper functioning of the Agenda Advisory Group, and as such, it should be able to be convened on short notice, if necessary. The Agenda Advisory Group should also vote (and provide that information in an advisory capacity to the FASB Chairman, who would make the final agenda decision), thereby maintaining transparency and improving accountability. Lastly, the Agenda Advisory Group would include active involvement of the SEC in referring agenda matters in a transparent and timely manner. These are functions that FASAC does not currently perform, although representation similar to that currently enjoyed by FASAC members would be instrumental to the proper functioning of the formal Agenda Advisory Group.

In creating such a formal Agenda Advisory Group, the SEC and FASB should consider the following additional elements:

- Active user/investor involvement.
- Timeliness. The Agenda Advisory Group should be convened both on a regular schedule, as well as, as noted above, on short notice telephonically to deal with urgent matters, as necessary.
- Transparency and accountability. The Agenda Advisory Group should vote on certain aspects of the standard-setting agenda and provide that information in an advisory capacity to the FASB Chairman, who would make the final agenda decision. Part of the rationale for calling a vote would be to maintain transparency and increase accountability of the FASB Chairman to the FAF regarding the effectiveness of agenda decisions.

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- Involvement by the SEC. One or more senior representatives from the SEC Office of the Chief Accountant should be on the Agenda Advisory Group, as the SEC often identifies practice issues prior to the designated private-sector standard-setter. In addition, active involvement of the SEC will help coordinate how and by whom guidance should be issued, thereby reducing the impetus for the SEC to issue interpretive implementation guidance.
- Openness versus timeliness. The general preference for open due process should be balanced with the need for ensuring timely advice on emerging issues so that the benefit of being able to build consensus on who is best able to deal with emerging issues may be achieved.
- Involvement by the FASB Board. All FASB Board members should be invited as official observers of the Agenda Advisory Group so that they may hear the views of various constituents directly.
- Involvement by the PCAOB. A senior representative from the PCAOB should be an official observer of the Agenda Advisory Group, as actions taken by the PCAOB significantly impact behavior of participants in the U.S. financial reporting community.
- Involvement by others. Constituents otherwise not represented on the Agenda Advisory Group should be able to present agenda requests, similar to the function of the current EITF Agenda Committee.
- Framework for agenda setting. A framework similar to that currently used by the EITF Agenda Committee should be developed that may assist the formal Agenda Advisory Group with making agenda setting and prioritization decisions.

Field Visits, Field Testing and Cost-Benefit Analyses: The FASB often visits with a number of interested constituents regarding particular standards as they are being deliberated, referred to as field visits. During development of a standard, usually prior to issuance of an Exposure Draft, the FASB may choose to conduct field visits for the purpose of assessing the costs and benefits or operationality of the proposed standard. During the comment period, the FASB may also conduct field tests, during which the adoption of a proposed standard is actually tested so that issues may be identified and resolved. However, as a practical matter and in consideration of resource constraints, the setting of many recent standards has not included robust field testing.

The FASB evaluates whether the benefits of each new standard justify its costs by determining that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the perceived overall benefits. However, participants in the standard-setting process have long acknowledged that reliable, quantitative cost-benefit calculations may seldom be possible, 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 preparers using the standard in the preparation of financial statements, auditors auditing that information, regulators regulating it, and users/investors

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assessing the benefits of the resulting accounting and disclosure. Further, cost-benefit considerations are sometimes based largely on anecdotal evidence, which does not consistently include preparers, auditors, users/investors, and regulators.

The Committee believes the FASB could improve its procedures for field testing, field visits and cost-benefit analyses. Specifically, scalable field tests, field visits and cost-benefit analyses should be a required part of the standard-setting process for all new standards. The rigor required in each of these procedures should be scaled based upon active consideration by the FASB of the length, difficulty and magnitude of impact of the accounting standard or interpretive implementation guidance, and the FASB may conclude that field visits and field tests may not be warranted for certain standards or interpretive implementation guidance.

Ideally, field visits, field testing and cost-benefit analyses would occur at the same time, as the same participants would be involved in each for a particular standard. Therefore, the FASB should continue to leverage work already being done by preparers, auditors, task forces and user/investor groups to assess the impact, operationality and auditability of proposed standards to help inform its views. Requesting assistance from preparers, auditors and users/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, field test and cost-benefit analysis. Many of these processes occur today, but additional benefits may ensure if they were consistently done in a more timely, systematic, and transparent fashion as a matter of policy.

The FASB is currently considering new initiatives to improve its field testing and cost-benefit analyses. The Committee supports the FASB's efforts in this regard and as a complement to that initiative, the FASB should consider the following improvements to its existing cost-benefit procedures:

- Select preparers, auditors, users/investors and regulators to be involved based upon their interest in the standard or interpretive implementation guidance being developed.
- Improve the transparency around the amount of work that is currently done by exposing the entire 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 those conclusions.
- 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.
- 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 those concerns

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in the analysis rather than omitting the data. A cost estimate and how it was arrived at should be requested from constituents who claim that costs are excessive.

- Add auxiliary information to put the accounting standard or interpretive implementation guidance into context (e.g., expectation of the impact of the standard on the number of companies, overall market capitalization metrics of constituents expected to be impacted).
- Improve the discussion of the cost-benefit conclusions in the basis for conclusions of new standards so that it may be referred to over time when re-assessing the original cost-benefit conclusions as part of the post-adoption effectiveness reviews and reviews of the overall effectiveness of U.S. GAAP, as further described in developed proposal 3.5.
- Consider leveraging economist resources to assist the FASB staff in preparing and reviewing cost-benefit analyses.

***Conceptual Approach 3.A: The Committee is considering proposing that subject to the conclusions reached in the future deliberations of international considerations described above the SEC encourage a re-prioritization of the standard-setting agenda, which may include the following:***

- 1. Consider the Committee's proposals and the potential prioritization of those proposals.***
- 2. Verify, issue, and implement the codification of U.S. GAAP, including a re-codification of existing SEC literature, if needed, (see developed proposal 3.4) and removal of redundancies between SEC disclosure requirements and other sources of GAAP (See chapter 2).***
- 3. Continue efforts towards international convergence (jointly with the IASB).***
- 4. Complete the conceptual framework (jointly with the IASB).***
- 5. As further described in developed proposal 3.5, add phase II of the codification project to the agenda and consider whether GAAP should be systematically revisited, as follows:***
  - To be more coherent post codification.***
  - To remove redundancies and/or conflicts with the conceptual framework.***
  - As further described in developed proposal 3.2, to be less complex, where possible.***
  - As further described in conceptual approach 3.C, to be designed optimally.***
  - To readdress frequent practice problems (as identified by restatement volumes, input from the SEC, implementation guidance issued, frequently-asked questions).***
  - To amend, replace, or remove outdated standards.***
- 6. Create a disclosure framework that may be used by the FASB in the future when assessing what types of disclosures are necessary based upon the type of information being conveyed (See chapter 2).***
- 7. Address emerging issues that urgently require attention (either directly or through a delegate).***

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Background: The Committee recognizes that the priorities of both the SEC and the FASB are very difficult to manage; both organizations face significant challenges associated with competing priorities from a number of different constituents, as well as needing to manage both near-term and long-term priorities. In particular, the FASB has been constrained by its need and desire to fulfill its obligations under the Memo of Understanding with the IASB regarding international convergence matters. While commonly acknowledged as a priority in global standard-setting, the Committee recognizes that coordinating accounting conclusions amongst different Boards and staff is challenging.

However, as part of its proposed formal Agenda Advisory Group, the Committee is deliberating a conceptual approach regarding what the priorities of both the FASB and SEC should be in the current environment. The Committee plans to finalize its proposal after completing its deliberations on international considerations later in 2008, which would be expected to significantly impact its proposal. 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 the list of priorities being deliberated by the Committee as noted above.

Most of the Committee's proposed priorities for the SEC and FASB are self-explanatory, but one merits additional explanation, as follows:

Conceptual Framework: The completion of the conceptual framework, and a reconsideration of conflicts between the revised conceptual framework and U.S. GAAP, will be an important step to improving the coherence of U.S. GAAP. Specifically, the FASB should have such a conceptual framework that it may refer back to over time when setting standards to ensure cohesiveness and consistency. Many of the issues currently being addressed by the FASB as part of the conceptual framework project are challenging and will have a pervasive impact on U.S. GAAP. The Committee is highly supportive of the FASB's efforts in this regard. Due to the potentially significant impact on U.S. GAAP of changes to the conceptual framework, it will be important that constituents agree with the direction of the FASB; to do so, there may be opportunities during Board deliberations to further clarify what the specific impacts will be of recommended changes to the conceptual framework. The FASB should be careful to highlight those changes to prevent consequences that are unintended or misunderstood by users/investors, preparers, auditors and regulators.

Question for the Committee:

3.4) Do you agree with developed proposal 3.3? What revisions, if any, would you recommend?

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Question to be Subsequently Considered by the Committee:

3.5) Do you agree with conceptual approach 3.A? What revisions, if any, would you recommend?

## **VI. Interpretive Implementation Guidance**

As discussed more fully below, the Committee has developed the following proposal and conceptual approach regarding interpretive implementation guidance:

***Developed Proposal 3.4: The number of parties both formally and informally interpreting U.S. GAAP should be reduced. The SEC should coordinate with the FASB to clarify roles and responsibilities regarding the issuance of interpretive implementation guidance, which would further reduce uncertainty in the U.S. financial reporting community. Specifically, the following steps should be taken:***

- ***The first phase of the FASB's codification should be verified, issued and implemented in a timely manner.***
- ***So that the benefits of the FASB's codification efforts may be fully realized, the SEC should ensure that the literature it deems to be authoritative is able to be integrated into the FASB codification to the extent practicable, including through a re-codification of such literature if necessary.***
- ***Going forward, there should be a single private-sector standard-setter for all authoritative accounting standards and interpretive implementation guidance applicable to a particular set of accounting standards (e.g., U.S. GAAP, IFRS). For U.S. GAAP, the FASB should continue to serve this function. The SEC and the FASB should also continue to be judicious when determining when to issue interpretive implementation guidance.***
- ***In instances when the SEC identifies accounting matters that it believes may apply or should be applied broadly, the SEC should refer those items to the FASB as part of the formalization of the informal feedback loop that is currently in place.***
- ***All other sources of interpretive implementation guidance should be considered non-authoritative and should not be given more credence than any other non-authoritative sources that are evaluated using well-reasoned, documented professional judgments applied in good faith.***

**Background:** Historically, interpretive implementation guidance has proliferated from a variety of sources and, intentionally or not, becomes additional sources of U.S. GAAP that may add to the complexity in the financial reporting system, especially when questions exist about its authoritative nature or conflicts exist between interpretations. Over the past few years, the FASB has taken actions intended to reduce the proliferation

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of authoritative interpretive implementation guidance from different bodies, including being recognized by the SEC as the private-sector accounting standard-setter for U.S. GAAP and limiting the ability of other bodies to create authoritative guidance without Board ratification. The SEC staff is also a source of interpretive implementation guidance, such as through comment letters, staff speeches, staff accounting bulletins and other forms of guidance that, although typically non-authoritative, are often perceived in the marketplace as quasi-authoritative.

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 U.S. GAAP. The Committee applauds the FASB's foresight in working on such a project and recognizes the significant effort that the codification entails. The codification will (1) bring all sources of authoritative U.S. GAAP together by topic into a single, searchable database so that they may be more easily researched, (2) clarify what guidance is authoritative versus non-authoritative, and (3) put each standard into a more consistent format, to the extent possible.

Although the codification will not change the substance of U.S. GAAP, the codification should make it easier to apply U.S. GAAP by gathering in one place all the relevant authoritative literature. However, SEC literature, which has developed through different mechanisms, may not be as easily integrated into the FASB codification. The codification will similarly not deal with the root causes of the proliferation of interpretive implementation guidance, nor the behavior of participants in the U.S. financial reporting community.

Notwithstanding these concerns, the Committee is supportive of the FASB's efforts to issue, validate and implement the codified version of U.S. GAAP over the upcoming year. Completion of the FASB's codification project is an important aspect of clarifying roles and responsibilities between the SEC and the FASB by flattening the GAAP hierarchy to two levels and stating explicitly those sources that are authoritative and those that are not. With that in mind, the Committee proposes that the SEC work with the FASB to ensure that the FASB's draft codification is verified, issued and implemented in a timely manner so that its benefits may be realized as quickly as practical. To improve existing U.S. GAAP, the FASB should consider a second phase of the codification project that would systematically revisit U.S. GAAP, as further described in developed proposal 3.5. The SEC should ensure that all interpretive implementation guidance it deems to be authoritative is also codified, which may require a re-codification of the SEC literature itself so that the benefits of the FASB's codification project may be fully achieved.

Authoritative Guidance: The Committee believes that authoritative interpretive implementation guidance that is broadly applicable to a particular set of accounting

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standards (e.g., U.S. GAAP, IFRS) is best issued by a single, private-sector standard-setter such that the guidance may be immediately updated in the codified version of that set of accounting standards. For U.S. GAAP, the FASB should continue to serve this function. In addition, the SEC and the FASB should continue to be judicious when determining when to issue interpretive implementation guidance.

Feedback Loop: The SEC should formalize the mechanism by which it currently informally refers agenda topics to the FASB such that the FASB may be the sole issuer of authoritative interpretive implementation guidance that is broadly applicable, thereby reducing the need for the SEC to do so. A formal Agenda Advisory Group on which representatives from the SEC staff and FASB both sit (as further described in developed proposal 3.3) could facilitate the feedback loop during which specific registrant matters with broad applicability are formally referred from the SEC to the FASB. Such a process would also leverage post-adoption effectiveness reviews of accounting standards by the standard-setter (as further described in developed proposal 3.5) and would require the formalization of the frequent, informal communication mechanisms that were strengthened between the SEC and the FASB in recent years. Such a formal, transparent feedback loop would help identify and prioritize issues with broad applicability that require authoritative interpretive implementation guidance from the designated standard-setter directly in the codified version of U.S. GAAP.

Non-Authoritative Guidance: All other interpretive implementation guidance (e.g., industry guides, accounting firm guidance) should be considered to be non-authoritative (by virtue of the fact that it will not be included in the U.S. GAAP codification) and should therefore not have more credence than well-reasoned, documented conclusions based on other, potentially-conflicting non-authoritative interpretive implementation guidance applied using a professional judgment framework (see developed proposal 3.4). Although the FASB codification initiative will help clarify the role of authoritative versus non-authoritative interpretive implementation guidance, making meaningful improvements in financial reporting will be difficult if non-authoritative interpretive implementation guidance continues to have the perception it has today of pseudo-authority in the marketplace.

***Conceptual Approach 3.B: As a follow-up to developed proposal 3.4 to further reduce interpretive implementation guidance associated with U.S. GAAP, the Committee is considering proposing that the SEC further clarify its role vis-à-vis the designated private-sector standard-setter, as well as its internal roles and responsibilities, to mitigate the risk of its actions unintentionally driving behavior, as follows:***

- ***The SEC staff should clarify that registrant-specific matters are not authoritative forms of interpretive implementation guidance under U.S. GAAP that should be analogized to or applied more broadly than to the specific***

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*registrant in question as the source for preparers to make changes to their financial statements.*

- *In instances when the SEC staff identifies registrant-specific accounting matters that it believes may result in the need for interpretive implementation guidance or a clarification of an accounting standard under U.S. GAAP, the SEC staff should refer those items to the FASB as part of the proposed formal feedback loop and proposed formal Agenda Advisory Group (see developed proposals 3.3 and 3.4).*
- *The SEC staff should refrain from informally communicating interpretive implementation guidance that would result in a change in the application of U.S. GAAP.*
- *The FASB and SEC should continue to be judicious when issuing broadly-applicable interpretive implementation guidance under U.S. GAAP. However, when it is necessary for the SEC to issue such broadly-applicable interpretive implementation guidance, similar to the processes followed by the FASB such guidance should (1) be deliberated with open due process and subject to public comment to the extent practicable, (2) be clearly communicated as authoritative, and (3) be easily and immediately integrated into the re-codification of SEC literature (see developed proposal 3.4).*
- *The SEC staff should revisit internal procedures and/or take further steps necessary to improve the consistency of its views on the application of U.S. GAAP.*

SEC Due Process: The SEC (i.e., the full Commission) sometimes issues rules and interpretations that comprise part of authoritative U.S. GAAP. The Commission'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 open due process.

For example, 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 those 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 with conclusions on specific accounting interpretive implementation guidance issues. These letters are commonly referred to in the marketplace as pre-clearance. SEC staff may also issue public statements, such as Staff Accounting Bulletins (SABs), which are approved by the Chief Accountants in both Corp Fin and OCA. In addition, SEC staff give speeches and issue letters to industry expressing views on accounting topics.

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Consistency: The Committee considered how to improve internal processes between various Offices and Divisions within the SEC to improve the consistency of accounting advice given by the SEC staff. Although the Committee understands that there are processes in place to build consensus on accounting matters within the SEC, the Committee believes there is room for improvement in this regard. The possibility of inconsistent accounting advice emanating either across and within various Offices and Divisions within the SEC creates confusion in the marketplace.

The Committee also understands that processes exist for registrants to request reconsideration of conclusions expressed in either comment letters or in pre-clearance letters within Corp Fin and/or, to the extent it relates to interpretative implementation guidance under U.S. GAAP, by OCA, when a registrant may disagree with staff guidance or believes it is receiving inconsistent advice. However, registrants may not always use these processes for a number of reasons, such as: (1) to avoid additional delay and potential impact on market opportunities, (2) to avoid the risk of opening other accounting conclusions to reconsideration, and (3) for fear of possible retribution (misguided or not). Therefore, although the SEC staff has created checks-and-balances in the form of these reconsideration processes, they may not by themselves effectively address all consistency issues.

Registrant-Specific Guidance: Preparers and auditors may misconstrue registrant-specific accounting outcomes as quasi-authoritative forms of interpretive implementation guidance. However, the outcomes are typically fact-specific and are not always intended to be applied broadly. Nevertheless, preparers and auditors may overreact by applying those outcomes to similar, yet different sets of facts and circumstances, often believing that those outcomes require restatement.

The SEC staff advised the Committee that it does not intend for registrant-specific guidance and outcomes to be applied broadly to other registrants with potentially different fact patterns. The Committee believes that interpretive implementation guidance that is applicable only to specific registrants should not be required to be applied more broadly than to the specific registrant and recommends that the staff publicly communicate this view. This clarification would help (1) prevent preparers, auditors and other regulators from overreacting to actions taken by the SEC staff, (2) facilitate the application of reasonable professional judgment, (3) reduce the need for other parties to issue interpretive implementation guidance, and (4) support the Committee's proposal to refer broadly-applicable accounting matters that require interpretive implementation guidance to the designated private sector standard-setter.

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As noted above, the SEC staff also communicates with the public in various forms about broadly-applicable interpretive implementation guidance, including SABs,<sup>10</sup> letters to industry, staff speeches and training manuals. In addition, Corp Fin publishes and maintains interpretive implementation guidance on the SEC website. While all of these publications contain disclaimers as to their non-authoritative nature, most financial reporting participants consider those 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 in the past and continue to influence market behavior because they sometimes include SEC staff views that do supplement existing U.S. GAAP. SEC staff sometimes refers registrants to these publications to support the staff's view on registrant-specific matters. As such, many argue that such documents exemplify the SEC staff effectively setting accounting standards without open due process and point to restatements following their releases as evidence of their quasi-authoritative nature in practice.

Partially in response to these concerns, the SEC staff sometimes attempts to exercise restraint by not formalizing its views, which presents a different challenge. Over time, even these informal SEC staff views become known, although not broadly disseminated. This often results in others in the financial reporting community issuing interpretive implementation guidance that broadly attempts to communicate the SEC staff's views. This was likely one of the purposes of forming the Center for Audit Quality (CAQ), which appears to serve, in part, as a mechanism for the large audit firms to communicate with a unified voice to the marketplace about their direct communications with the standard-setters and regulators.

The Committee does not intend to limit the ability of the SEC staff to carry out its regulatory responsibilities in a timely fashion. That is why the Committee has not yet proposed a specific course of action in response to the concerns raised herein. The SEC staff is reviewing its procedures in a number of these areas and expects to unveil changes during the coming months, including procedures to enhance consistency of accounting interpretations during filing reviews and increase the transparency and usefulness of the

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<sup>10</sup> The Commission authorized the use of SABs in 1975 to achieve a wider dissemination of the administrative interpretations and practices utilized by the Commission's 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 not generally exposed for public comment before release.

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reconsideration processes. The Committee is fully supportive of the SEC staff's internal review process and plans to work with the SEC staff in its deliberations in the coming months.

Question for the Committee:

3.6) Do you agree with developed proposal 3.4? What revisions, if any, would you recommend?

Question to be Subsequently Considered by the Committee:

3.7) Do you agree with conceptual approach 3.B? What revisions, if any, would you recommend?

## **VII. Transition to and Design of New Standards**

As discussed more fully below, the Committee has developed the following proposal and conceptual approach regarding the implementation and design of standards so that they promote the use of reasonable judgments:

***Developed Proposal 3.5: The SEC should formally encourage an objectives-based approach to the way standards are designed and implemented, which would allow a reasonable amount of diversity in practice, as follows:***

- ***By encouraging standard-setters to refine transition guidance in new standards to make clear that a reasonable amount of diversity may exist following initial adoption of standards, which may allow the SEC to regulate compliance with new standards without forcing restatements that may not be material to users/investors, so long as the basic principles in U.S. GAAP are followed, including the importance of promoting comparability amongst preparers. Such implementation and transition guidance would continue to have a stated, required implementation date, but should acknowledge that diversity in practice post-implementation will be monitored and addressed by the standard-setter in the form of post-adoption effectiveness reviews to maintain an appropriate amount of comparability.***
- ***By encouraging post-adoption effectiveness reviews of new standards to be conducted by the standard-setter within a reasonable timeframe after adoption of new standards, as determined by the standard-setter based upon the scale of the standards themselves. By identifying diversity that develops during the review period that is perceived to undermine comparability, the standard-setters should take immediate action to reduce diversity through the standard-setting process, with appropriate transition provided to avoid restatements that may not be perceived as material to users/investors.***

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- ***By encouraging the standard-setter to also revisit all of U.S. GAAP for effectiveness on a periodic basis.***

Transition Guidance: The Committee noted that one of the significant complexities of the current financial reporting and regulatory environment is that preparers, auditors and other participants are sometimes viewed as being penalized for improving their understanding and interpretations of accounting standards over time. Said differently, if a preferred interpretation of a new standard develops after the standard has been implemented, early adopters may be forced to retain less preferable accounting or restate in future periods. This issue can be especially problematic for new standards. Furthermore, the fear of having reasonable, good-faith judgments overturned, may cause preparers, auditors and regulators to engage in defensive accounting and auditing.

Therefore, standard-setters should refine implementation and transition guidance in new standards to make clear that a reasonable amount of diversity may exist following initial adoption of new standards, which may allow the SEC to regulate compliance with new standards without forcing restatements that may not be perceived as material by users/investors, so long as the basic principles in U.S. GAAP are followed, including the importance of maintaining comparability. There will be a careful trade-off; within reasonable limits, comparability will not be undermined by permitting reasonable diversity, so long as the consequences are not material to investors.

The goal of such refinements would be that the accounting standards themselves would not be written with an attempt to close every loop-hole to prevent abuse, nor answer every implementation issue in advance. Rather, with objectives-oriented standards, the financial reporting community would accept some diversity in practice in early years, and not compel restatements as experience is gained, but make as appropriate prospective changes to properly address longer-term comparability.

This may be accomplished by the FASB providing a clear post-adoption effectiveness review period (review period) for all new standards (the length of which would be determined by the standard-setter based on the scale of the standard, but typically 1-2 years), during which time preparers may benefit from authoritative or non-authoritative interpretive implementation guidance to learn about how the standard is being interpreted and implemented without being forced to restate (except in clear cases in which the registrant fails to comply with the basic principles of the standard). Such a review period may require the FASB to adopt standard transition guidance written into all new standards, and, because the SEC regulates based upon the standards themselves, may have the effect of allowing the SEC to regulate in a more flexible manner.

However, this is not meant to imply that preparers should have the flexibility to implement new standards at different times. Rather, the review period would merely clarify that a reasonable amount of diversity may in some situations exist until the

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FASB's first post-adoption effectiveness review is completed. Thereafter, the standard-setter would re-evaluate the standard and may make additional amendments.

Nor is this proposal meant to usurp the SEC's authority to regulate abusive behavior. Clear violations of U.S. GAAP or inadequate disclosure would continue to be dealt with by the SEC through enforcement and the comment review processes. However, issues arising during the review period that are purely interpretive would be re-considered by the FASB either during or at the end of the review period in a post-adoption effectiveness review and standard-setting would be completed by the FASB to clarify the standard and reduce diversity in practice, as necessary.

Post-Adoption Effectiveness Reviews: After a new accounting standard has been in place for a reasonable period of time, more data are likely to be available to evaluate its cost, efficacy, utility and/or relevance in the current environment. However, currently the FASB does not have a formalized, transparent process in place to do post-adoption effectiveness reviews of new standards in an agreed-upon timeframe or a broader effectiveness review of U.S. GAAP on a systematic basis. As such, standards may miss important matters, not properly consider implementation issues, have unintended consequences, and may lose their relevance and effectiveness over time. As a consequence, useful financial information might not be made available to the users of financial statements.

The FASB has a stated mission and precept that obligates it to perform such effectiveness reviews,<sup>11</sup> and in satisfaction of those requirements, the FASB regularly receives input from various constituents and periodically revisits some of its standards. However, the Committee believes that the process by which post-adoption effectiveness reviews are completed should be formalized in policy, be more systematic, be more transparent, involve input from a broader range of constituents, and be monitored using relevant performance metrics. The benefit of doing so would be to remove much of the uncertainty that exists in the marketplace around when, how and from whom interpretive implementation guidance will be issued. As noted earlier, the uncertainty is a direct consequence of the fear of being second-guessed and is a symptom of the tendency to engage in defensive accounting and auditing. By formalizing the process, the Committee hopes to diffuse some of those fears and change behavior of participants in the financial reporting community.

The goal of post-adoption effectiveness reviews would be to assess whether or not the accounting standard accomplished its intended purpose, or whether it had unintended consequences that need to be resolved. Specifically, as a matter of policy, the FASB

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<sup>11</sup> Part of the FASB's stated mission is to "Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process" and one of the FASB's stated precepts in the conduct of its activities is "To review the effects of past decisions and interpret, amend or replace standards in a timely fashion when such action is indicated."

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should conduct formal post-adoption effectiveness reviews of new standards within 1-2 years of implementation (or earlier, based upon facts and circumstances as evaluated by the standard-setter) to do the following:

- Deal with implementation matters that arise.
- Ensure that only an acceptable amount of diversity in practice exists.
- Ensure that the accounting that is being produced is what the standard-setter intended and is useful to readers of the financial statements.
- Reassess the cost-benefit analysis, as necessary.

Reviews of the Effectiveness of U.S. GAAP: In addition, the SEC and the standard-setter should perform a similar effectiveness review of U.S. GAAP periodically to formally consider the following:

- Input from users/investors, preparers, auditors and regulators about standards that may be improved or eliminated.
- Practice problems identified by the SEC.
- Restatement activity.
- The amount of interpretive implementation guidance required since that last post-adoption effectiveness review.
- The costs and benefits of standards (or accounting models in general).
- The need to amend, replace or remove outdated standards.
- Opportunities to be more coherent post codification (see conceptual approach 3.A).
- Opportunities to reduce avoidable complexity.
- Opportunities to migrate to an optimal design of standards (see conceptual approach 3.C).

Some participants in the financial reporting community have commented that there are a small number of accounting standards that are in immediate need of re-evaluation. The Committee believes that the formalization of a process for the standard-setter to receive, evaluate, and address such input is critical to the proper functioning of the U.S. capital markets. However, making a determination on specific standards would best be left to the FASB, with oversight from the FAF and input from the formal Agenda Advisory Group that assists with agenda-setting priorities.

The Committee has considered the recent *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB* issued by the FAF and believes that FAF's proposed changes to increase its monitoring of the FASB's effectiveness complement the Committee's proposal. The FAF should closely oversee whether post-adoption effectiveness reviews and periodic reviews of the overall effectiveness of U.S. GAAP are adequately implemented to ensure that they occur in a timely fashion.

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Impact on Standard-Setting: The Committee acknowledges that many of the aspects included in its proposal for post-adoption effectiveness reviews and overall GAAP effectiveness reviews occur in practice today. The Committee is supportive of the ongoing efforts of the FASB to accomplish these reviews and recognizes that its current convergence efforts and other pressing needs make agenda prioritization difficult. Formalizing these processes, including creation of the proposed Agenda Advisory Committee, and increasingly leveraging the FAF trustees and participants in the preparer, auditor, user/investor, and regulatory communities may increase the efficiency and effectiveness of these review procedures. In addition, the FAF and FASB should consider whether other increases in staffing may be required to facilitate the proposals herein.

***Conceptual Approach 3.C: As a follow-up to developed proposal 3.5, the Committee is considering proposing that the SEC formally encourage improvement in the way standards are written, as follows:***

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

Professional Judgment: Chapter 4 of the report discusses a proposal regarding the creation of such a professional judgment framework. The success of such a framework is a condition precedent to the developed proposals and conceptual approaches in this chapter, for the following reasons:

The Committee believes that the fear of having reasonable, good-faith judgments overturned significantly influences the behavior of participants in the U.S. financial reporting community and results in non-authoritative literature being perceived as quasi-authoritative in the marketplace. A professional judgment framework would change behaviors of participants in the financial reporting community, thereby making the standard-setting system in the U.S. more efficient. In proposing such a step, the Committee believes that such a framework will be dependent on changes in behavior from all participants in the financial reporting process, including preparers refraining from engaging in practices commonly construed as earnings management and gatekeepers, including auditors and underwriters, diligently serving their intended roles in the marketplace.

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Such changes in behavior – by preparers and auditors who should apply accounting standards faithfully and invoke the use of professional judgment only when appropriate – and by the regulatory and legal communities, who should exercise professional skepticism while respecting reasonable professional judgments made in good-faith – would rebalance the system of checks-and-balances that is critical to the efficient functioning of the U.S. capital markets. It would also enable a simplification in the design of standards and reduce the demand for further detailed interpretive implementation guidance in response to defensive accounting and auditing. This would allow the standard-setters to revisit U.S. GAAP with an eye to making its requirements easier to understand and apply. Without such changes in behavior by all parties, meaningful improvements in the standard-setting process will be difficult.

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. The objectives and principles inherent in existing U.S. GAAP are sometimes overwhelmed by detailed rules, examples, scope exceptions, safe harbors, cliffs, thresholds and bright lines. In addition, U.S. GAAP is not typically written in plain English. This makes it difficult for preparers and auditors to apply the standards' underlying objectives and principles, which creates risk that the appropriate rule is not identified and considered, and causes uncertainty in application, because rules cannot cover all possibilities. This, in turn, may drive requests from preparers, auditors and regulators to answer every question in the form of more prescriptive rules, examples and additional guidance (termed earlier as defensive accounting and auditing). The result is an accounting system that is overly complex, has little room for professional judgment, and can engender a check-the-box approach.

The Committee recognizes that the question of how to design standards going forward is at the center of a decade-long principles-based (or objectives-oriented) versus rules-based accounting standards debate. Rather than engaging in such a debate, the Committee prefers to think of optimal accounting standards in terms of what characteristics they might possess. The Committee is considering various suggestions on the optimal design of standards, including the work of the CEOs of the World's Six Largest Audit Networks, who are attempting to build consensus about what optimal accounting standards might look like in the future and whether a framework should be created that the standard-setters may refer back to over time to ensure that such characteristics are optimized. The latest step in this effort was the creation of such a draft framework, which will be presented at the Global Public Policy Symposium in January 2008.

The Committee is supportive of these efforts and understands that the draft framework will likely recommend that optimal accounting standards have the following characteristics:

- Faithful presentation of economic reality,
- Responsive to users' needs for clarity and transparency,

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- 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; and
- Allows for the use of reasonable judgment.

In addition, in his testimony before the United States Senate Subcommittee in Securities, Insurance and Investment on 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: (1) whether they can be explained simply in a matter of a minute or so, and (2) they make intuitive sense.

Future Considerations: The Committee also plans to further deliberate what optimal transition guidance should be in the future that would balance user/investor needs for consistent information with feasibility and cost considerations associated with recasting historical information during the retrospective adoption of new accounting standards.

Question for the Committee:

3.8) Do you agree with developed proposal 3.5? What revisions, if any, would you recommend?

Question to be Subsequently Considered by the Committee:

3.9) Do you agree with conceptual approach 3.C and future considerations? What revisions, if any, would you recommend?

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## CHAPTER 4: AUDIT PROCESS AND COMPLIANCE

### I. Scope

The Committee has concentrated its efforts to date primarily on the subjects of financial restatements and whether the provision of guidance with respect to the materiality of errors and how to correct errors would be beneficial. The Committee has also considered professional judgment and whether a judgment framework would enhance the quality of judgments and the willingness of others to respect judgments made.

Question for the Committee:

4.1) Do you agree with the plan in the area of audit process and compliance?

### II. Financial Restatements

#### II.A. Background

##### Potential Causes of Restatements

A significant and increasing number of restatements<sup>12</sup> have occurred in the U.S. financial markets in recent years. 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<sup>13</sup> (and discussions regarding materiality in SAB

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<sup>12</sup> For the purposes of this chapter, a restatement is the process of revising previously issued financial statements to reflect the correction of an error in those financial statements. An amendment is the process of filing a document with revised financial statements with the Commission 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 Commission.

<sup>13</sup> 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).

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99, *Materiality*, (as codified in SAB Topic 1M)) (i.e., resulting in errors being deemed to be material when an investor may not consider them to be important).

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.<sup>14</sup> The Committee recommends that public companies focus on reducing errors in financial statements. At the same time, some of the other recommendations of this Committee, such as those that address the current complexity of financial reporting and improving the standard setting process, 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 any unnecessary restatements (i.e., those that do not provide important information to investors). Unnecessary restatements can be costly for companies and auditors, reduce confidence in reporting, and create confusion that reduces the efficiency of investor analysis. This portion of this chapter describes the Committee's recommendations regarding (1) additional guidance on the concept and application regarding materiality and (2) the process for and disclosure of the correction of errors.

### **Committee Research**

The Committee has considered several publicly-available studies on restatements.<sup>15</sup> The Committee is aware that the Treasury Department also 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. The Committee will review the Treasury Department's study and consider its findings as they are made available.

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<sup>14</sup> Glass Lewis & Co. report "Brief Alert Weekly Trend" issued December 17, 2007 shows that restatements in companies subject to Section 404 of the Sarbanes Oxley Act have declined for two consecutive years.

<sup>15</sup> Studies considered include the U.S. Government Accountability Office (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). The Committee has also considered findings from the PCAOB's Office of Research and Analysis's (ORA) working paper released October 18, 2007, "Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era," understanding that ORA's findings are still preliminary in nature as the study is still going through a peer review process.

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The restatement studies all indicate that the number of restatements has increased in recent years. Market reaction to restatements might be one indicator of whether or not restatements contain information considered by investors to be material. While there are limitations<sup>16</sup> to using market reaction as a proxy for materiality, based on these studies, it would appear that there may be many restatements occurring that investors may not consider important due to a lack of a statistically significant market reaction. The Committee believes that 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.

The Committee has also considered input from equity and credit analysts and others about investors' views on materiality and how restatements are viewed in the marketplace. Feedback 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 or not.
- 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 on restatements is not consistently adequate to allow a user 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 its work to date, the Committee believes 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? (2) How should a material error in previously issued financial statements be corrected? The Committee believes that framing the principles necessary to evaluate these questions would be helpful. The Committee also believes that in many circumstances investors could benefit from improvements in the nature and timeliness of

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<sup>16</sup> Examples of the limitations in using market reaction as a proxy for materiality include (1) the difficulty 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 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.

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disclosure in the period between identifying an error and filing restated financial statements.

With this context, the Committee has developed the following proposals regarding the assessment of the materiality of errors to financial statements and the correction of financial statements for errors.

**Developed Proposal 4.1: Materiality**

***The Commission or its staff should issue guidance<sup>17</sup> 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 impacts the total mix of information available to a reasonable investor.***
- ***Just as qualitative factors can lead to a conclusion that a quantitatively small error is material, qualitative factors also can lead to a conclusion that a quantitatively significant error may not be material. The evaluation of errors should be on a “sliding scale.”***

***The Commission should also direct its staff to conduct both education sessions internally and outreach efforts to auditors and financial statement preparers to raise awareness of these issues and to promote more consistent application of the concept of materiality.***

The Committee believes 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. The Committee believes 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 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.

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<sup>17</sup> To the extent that the implementation of the Committee’s recommendations would require a change to GAAP, the Commission should work with the appropriate standard setters to revise GAAP.

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The Committee believes 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 insignificant error material, but a quantitatively significant error is material without regard to qualitative factors. The Committee believes that qualitative factors not only can increase, but also can decrease, the importance of an error to the reasonable investor. Specifically, the Committee believes 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 a “checklist” whereby the presence of any one of these items would make an error not material. Companies and their auditors should still 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 forward to reducing unnecessary restatements.

Question for the Committee:

4.2) Do you agree with the recommendations on materiality to annual financial statements? Are there any areas you would recommend adding or removing?

**Developed Proposal 4.2: Correction and Disclosure of an Error**

***The Commission or its staff 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.***

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- *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 may need to be disclosed and/or 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.*
- *The current disclosure about the need for a restatement, during the period when the restatement is being prepared and about the restatement itself is not consistently adequate for the needs of investors and needs to be enhanced.*

The current guidance that is detailed in SAB 108 (as codified in SAB Topic 1N) may result in the restatement of prior annual periods for immaterial errors 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. The Committee believes that prior annual period financial statements should not be restated for errors that are immaterial to the prior annual period. An alternative to the approach specified in Topic 1N could be to require 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<sup>18</sup> with appropriate disclosure.

The Committee believes 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 Commission 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.

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<sup>18</sup>The Committee is 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. The Committee believes that there are merits in both approaches and that the Commission and its staff should carefully weigh both approaches before determining the actual approach to utilize.

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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, instead of amending previous filings with the Commission. This option should be further studied and, if appropriate, should be included in the guidance.

When evaluating the need to restate when an error is discovered that relates to an interim period within an annual period for which financial statements have previously been filed with the Commission, 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 only be material 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 10-K should not be amended).

The Committee believes that all errors, excluding clearly insignificant errors, should be corrected<sup>19</sup> no later than in the financial statements of the annual or interim period in which the error was discovered. 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.

Typically, the restatement process involves three primary reporting stages:

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

The Committee believes that one of the major effects on investors related 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 discounts of the company's stock price. In addition, delays in filing restated financial

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<sup>19</sup> The Committee understands 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.

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statements may create default conditions in loan covenants; these delays may adversely affect the company's liquidity. The Committee understands that, in the current legal environment, companies are often unwilling to provide disclosure of uncertain information. However, the Committee believes that when companies are going through the restatement process, they should be encouraged to continue to provide whatever financial information they can provide accompanied by appropriate explanation of ways in which the information could be affected by the restatement if the information is believed by management to be reasonably reliable given the circumstances. 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.

The Committee believes that the current disclosure surrounding a restatement is often not adequate to allow users to evaluate the company's operations and the likelihood that such errors could occur in the future. Specifically, the Committee believes 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:

**Nature of error**

- Description of the error.
- Periods affected and under review.
- Items in each of the financial statements subject to the errors 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, or 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 or other consequences of the restatement.

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Companies should update this disclosure on a periodic basis during the restatement process, particularly when quarterly or annual reports required to be filed as material changes become known, with full and complete disclosure within the filing with the Commission that includes the restated financial statements.

The Committee believes that by providing this guidance on how to correct and disclose errors in previously issued financial statements, investors will receive higher quality information (e.g., prior periods will not be restated for immaterial items and for errors that have no relevance to current investors, and more consistently good disclosure will be made during and about the restatement process) and the burdens on companies related to unnecessary restatements will be reduced.

Questions for the Committee:

- 4.3) Do you agree with the proposal regarding the consideration of current investors in determining the need to restate?
- 4.4) Do you agree with the concept that prior periods should not be restated except for material errors?
- 4.5) Do you agree with the proposal regarding additional disclosures during the restatement process and surrounding the restatement? Are the proposed disclosures sufficient? Do the proposed disclosures create too much of a burden on companies? Are additional or different disclosures needed for investors?
- 4.6) Do you agree with the concept that all errors, except clearly insignificant errors, should be corrected no later than in the financial statements of the annual or interim period in which the error was discovered?

**Developed Proposal 4.3: Errors related to interim periods**

Based on available 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*.<sup>20</sup> 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,

<sup>20</sup> “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.”

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and also impacts investors, who can be confused by the inconsistency between companies in evaluating and reporting errors. The Committee believes that guidance on how to evaluate errors related to interim periods would be beneficial to preparers, auditors and investors.

The Committee has 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, the Committee believes 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) If an error is material, what should be the acceptable methods for correcting an error in previously issued interim financial statements? The Committee believes that additional guidance on these questions, which are extensions of the basic principles outlined in developed proposals 4.1 and 4.2, respectively, would provide useful guidance in assessing and correcting interim period errors. The Committee believes while these principles will assist in developing guidance related to interim periods, the Committee believes that additional work should be done to fully develop robust guidance regarding errors identified in interim periods.

***The Commission or its staff 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 4.2.***

The Committee believes 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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The Committee believes 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.

The Committee also notes 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.

Question for the Committee:

4.7) Do you agree with the proposal and principles outlined above related to evaluating materiality and correcting errors with respect to interim 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 has 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. 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 where 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

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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. Lack of confidence by investors 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. Concern by preparers and auditors 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 judgments are as follows:

#### **1. Selection of accounting standard**

In many cases, the selection of the appropriate GAAP is not a highly complex judgment (e.g., you would account for a lease using lease accounting standards, pensions using pension accounting standards, etc.). However, there are cases when 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

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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 in which experienced accounting professionals can have legitimate differing, yet acceptable, opinions.

## 2. Implementation of an accounting standard

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

Examples of implementation judgments include determining if a hedge is effective or not, determining if you have an operating or capital lease, and determining what inputs and methodology should be utilized in a fair value calculation. Implementation judgments can be assisted by implementation guidance issued by standard setters, regulators or 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.

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.

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For example, there are typically not significant differences of opinions on the appropriate standard to account for loan losses or to measure impairments of assets. However, the assumptions and methodology used by management to actually determine the allowance for loan losses or 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 would 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, or 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 disbursement made after the period-end. This evidence allows the auditor to determine whether the accrual for unpaid expenses at year-end is adequate.

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However, the use of hindsight to evaluate 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*,<sup>21</sup> can be difficult, particularly for regulators who are often evaluating these circumstances after substantial time has passed. Therefore, the use of hindsight should only be used based upon the facts reasonably available at the time the annual or interim financial statements were issued.

### **Form of Framework**

Some have recommended 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. However, it is unclear to the Committee whether a legal or regulatory safe harbor (i.e., an effective legal or regulatory defense based on conformity with the framework) can be adopted by the Commission or whether it would require changes in existing statutes. The Committee encourages the Commission and its staff to resolve this issue.

Another approach is for the Commission and the PCAOB to issue policy statements that describe a framework for the exercise of professional judgment and states that auditors, the Commission 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 Commission has utilized similar frameworks in the past with success. Examples of previous frameworks by the Commission include the “Seaboard” report (October 23, 2001) on the relationship of cooperation by a company to taking action in an enforcement case and the Commission’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 policy statement or safe harbor might also enhance the quality of judgments by providing a rigorous structure for how judgments should be made, which would also provide protection to investors as to the quality of financial statements.

### **The Nature and Limitations of Generally Accepted Accounting Principles:**

Some have suggested that the standard in a potential judgment framework for the selection and implementation of GAAP contain a requirement to reflect the economic

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<sup>21</sup> The Committee believes that those making a judgment should be expected to exercise due care in gathering all of the relevant facts prior to making the judgment.

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substance of a transaction or be a standard of selecting the "high road" in accounting for a transaction. The Committee agrees that qualitative standards for GAAP such as these would be desirable and we encourage regulators and standard setters to move financial reporting in this direction. However, such standards are not always present in financial reporting today and we could not 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, a less preferable alternative is fully acceptable absent such a change.

The Committee believes that adopting a requirement for economic substance or for taking the "high road" would require a revolutionary change not achievable in the foreseeable future and probably not worthy of serious attention until a principles-based approach to GAAP is uniformly applied and "rules" no longer govern GAAP; our suggested judgment framework can and we believe will enhance adherence to GAAP but cannot be expected to correct inherent weaknesses in the standards to which it is applied.

### **III.B. Developed Proposals**

The Committee has developed the following proposals:

***Developed Proposal 4.4: The Commission should issue a policy statement or adopt a safe harbor on a professional judgment framework consistent with the concepts outlined below. The Commission should also encourage the PCAOB to consider similar action. Careful consideration should be made in implementing any***

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*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 would be applicable to accounting related judgments, including the choice and application of accounting principles, as well as the estimates and evaluation of evidence related to the application of an accounting principle. The Committee believes that a framework that is consistent with the principles outlined in this framework to cover judgments made by auditors based on the application of PCAOB auditing standards is very important and would be beneficial to preparers, investors and auditors. Therefore, the Committee recommends that the PCAOB develop a professional judgment framework for the application of and evaluations of judgments made based upon PCAOB auditing standards.*

## **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 forms 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 and regulators will accept the judgment. Conversely, not following the framework would not imply that the judgment is unreasonable.

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This framework also acknowledges that generally accepted accounting principles do 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. Therefore, 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 and level of effort in making a professional judgment would vary based on the complexity, nature (routine vs. 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:

- a) Analysis of the transaction, including the substance and business purpose of the transaction;
- b) The facts reasonably available at the time that the financial statements are issued;
- c) A thorough review and analysis of relevant literature, including the relevant principles;
- d) Alternative views or estimates, including pros and cons for reasonable alternatives;
- e) Rationale for the choice selected, including reasons for alternative or estimate selected and linkage of rationale to investor's information needs and the judgments of competent external parties;
- f) Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated;
- g) Diversity in practice regarding the alternatives or estimates;<sup>22</sup>
- h) Consistency of application of alternatives or estimates to similar transactions; and
- i) 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 sufficiently transparent to inform the user of the financial statements about the substance of the transaction, including the relevant rights, obligations, risks and rewards, the relevant accounting principles, and the key

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<sup>22</sup> If there is not diversity in practice, it would be significantly harder to select a different alternative.

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assumptions that went into 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 make it more difficult to support an assertion as to the nature and propriety of a judgment made at the time of the release of the financial statements.

Questions for the Committee:

- 4.8) Do you agree with the developed proposal that a professional judgment framework could be useful or should the focus be more on providing guidance on the use of professional judgment? What changes, if any, would you suggest?
- 4.9) Do you agree that the form of the framework should be a policy statement, with a “safe harbor” only being explored depending upon experience with the policy statement and the need for such a safe harbor in order to enhance the use of principles-based accounting standards?
- 4.10) Do you agree with the proposed framework? Do you have any comments regarding the proposed applicability or components of the framework?
- 4.11) Does the framework sufficiently cover all types of judgments (e.g., not only choice and application of accounting principles, but making estimates and the appropriate way to evaluate the evidence used to make the judgment)? Are there types of judgments for which the framework would not work? What modifications would be appropriate?
- 4.12) Should disclosure be required as a separate component of the framework rather than simply be considered depending upon whether disclosure is otherwise required by the Commission or GAAP? Are there other components that may be needed?

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## CHAPTER 5: DELIVERING FINANCIAL INFORMATION

### I. Scope

The Committee has 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, the Committee has recognized that the information needs of different types of investors are not always the same. The Committee has agreed that information delivery must be provided in a manner that will make it efficient, reliable, and cost-effective for each of the relevant investor groups and will not significantly increase burdens on reporting companies.

The Committee has determined to focus its 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.<sup>23</sup> The Committee believes that it can provide some useful recommendations to enhance ongoing reporting that will enable investors to better understand reporting companies.

Based on the above, the Committee has analyzed a number of ways to improve the delivery of financial information to investors and the market. These are:

- Tagging of financial information (XBRL)
- Improved corporate website use

The Committee also intends 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 and other metrics to enhance business reporting
- Improved quarterly press release disclosures and timing
- Continued need for improvements in management discussion and analysis (MD&A) and other public company financial disclosures

In furtherance of its work, the Committee has considered the views of various constituents in the financial reporting process regarding the use of XBRL. The Committee also has evaluated other information disclosure models, including those

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<sup>23</sup> The Committee has determined 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, the Committee viewed information delivery relating to ongoing company reporting by public companies as the area needing greater focus.

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involving enhanced uses of technology and corporate websites. The Committee intends to continue to evaluate the use of summaries as a component of periodic reports and ways in which financial disclosures by reporting companies can be improved.

Question for the Committee:

5.1) Do you agree with the preliminary scope in the context of information delivery? What areas, if any, would you recommend adding or removing?

## **II. Tagging of Financial Information (XBRL)**

### **II.A. Background**

#### **Description of XBRL**

The Committee has been examining the use of XBRL by public reporting companies because the SEC is moving rapidly in this area. In particular, the Committee has been examining the use of XBRL under the Exchange Act reporting regime.

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 also offers benefits to companies by allowing them to better control how their financial or non-financial information is disseminated and, by integrating their operating data with their financial reporting disclosure, to reduce reporting costs. XBRL is a computer language that permits the automation of what are now largely manual steps for access, validation, analysis and reporting of disclosure. Because XBRL uses standardized XML (eXtensible Markup Language) technology, it can be read by a wide range of diverse software systems.

Under current technology, for example, if an investor or analyst wants to compare the sales of all the pharmaceutical companies, he must download the financial statements of these companies and input the sales data into a spreadsheet. With XBRL, however, widely available software applications will be able to take the information companies submit to the SEC's EDGAR system, extract the sales numbers and download them directly to a spreadsheet. This process will take seconds rather than the hours or days that might be required using current methods.

XBRL does this through standardized definitions of terms, like a dictionary. For example, there might be several terms for the top line on an income statement, which might be called sales, turnover or revenues. All of these terms mean the same thing, and are translated in XBRL into a common symbol, readable by a computer. When

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reproduced as a financial statement from the XBRL source, the statement will look exactly like the statement that the company produced for reading by humans.

The standardized terms are then arranged in a logical structure called a taxonomy. Under sales, for example, there might be several subcategories, such as sales through retailers, sales over the Internet, etc. These would be similarly standardized and included under sales (or turnover or revenues) because they are all aggregated to produce the number for sales. That logical structure is 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.

XBRL also contains standardized relationships, such as EBITDA, so that if an investor or analyst wants to know the EBITDA of each of the pharmaceutical companies he would simply query the SEC's EDGAR system with the appropriate search application. The numbers would again be able to be downloaded in seconds. There would be no need to download the complete financial statements, ferret out the constituents of EBITDA and do the necessary calculations. The standardized XBRL concept of EBITDA embedded in XBRL provides all the explicit rules that enable a search engine to find the specifically identified concepts necessary to compute the number.

### **Status of XBRL Tagged Financial Statements in SEC Reports**

The SEC has adopted a voluntary pilot program for use of XBRL in which participants submit voluntarily supplemental tagged financial information using the XBRL format as exhibits to specified EDGAR filings.<sup>24</sup> 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 has 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 the draft of U.S. GAAP taxonomies and draft preparer's guide for public testing and comment. The 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 is anticipated that the final taxonomy and preparer guidance will be issued in Spring 2008. After the final

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<sup>24</sup> 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."

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taxonomy and preparer guidance is issued, the SEC EDGAR system must be modified to permit submissions tagged using such U.S. GAAP taxonomies.

The SEC has stated that it will use the initial financial statements prepared using the new 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.” The Committee understands that currently, the SEC’s EDGAR system does not yet accept and render financial statements with XBRL tags based on the newly developed U.S. GAAP taxonomy.

In addition, the Committee understands 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 to tag their financial statements as part of an integrated approach to financial reporting. In an integrated approach, companies incorporate XBRL into their internal company financial systems. This integrated approach allows financial reports to be created from the XBRL tagged financial systems, without such financial statements first being prepared 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. 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. 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.

### **Time and Costs Involved in XBRL Tagging**

The Committee understands that while the 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 U.S. GAAP. The Committee understands 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. The Committee understands a related issue deals with the need for customized “extensions” if the U.S. GAAP taxonomy does not include a tag for the particular item in the company’s financial statements. Because the U.S. GAAP taxonomies currently out for public comment track U.S. GAAP, the Committee believes that there likely will be less need for customized extension elements. One of the purposes of the comment period is to identify additional tags or elements that should be added to the taxonomy, reducing the need for customized

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extensions. The draft preparer guidance also out for public comment should be evaluated by preparers, users, and others to determine if it provides adequate guidance for determining when an extension should be used by preparers.

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 under existing standard taxonomies (not the new U.S. GAAP taxonomies) using 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).<sup>25</sup> 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.

Thus, the type of information that is tagged also is relevant to understanding XBRL tagged financial statements. Companies 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.

### **Smaller Public Company Reactions to XBRL Tagging**

Smaller public company representatives recognize the benefits that XBRL would have for these companies long term, but are concerned about initial implementation costs, which development of improved tagging and verification software could help alleviate. The representatives strongly support a phased-in approach in which such smaller public companies would be included at the end, once the 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**

The Committee sees the following potential benefits of XBRL for reporting companies and users of financial and non-financial information:

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<sup>25</sup> For example, for one S&P 500 company participating in the voluntary pilot, 80 hours was spent learning the tagging tool, understanding SEC requirements, creating extensions for tags, and creating a process for ongoing tagging and future submissions.

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- Benefits to reporting companies
  - Improved communications with analysts and investors
    - Release of corporate data could be instantaneous and immediately usable – data can be immediately assimilated into analysts’ models; there is no need to wait for third party aggregators or staff to input the data into their own format and to transmit it to subscribers
    - Reduction in search costs both for preparers and users
    - Because of reduced search costs, there is potential for increased coverage of companies, especially mid-size and smaller companies, by sell-side and buy-side analysts, and at both major brokerage and independent research firms
  - Improved quality of data<sup>26</sup>
    - Because manual input is eliminated, there will be reduced error rates in reporting and inputting of corporate data by aggregators
    - Because aggregators will not be necessary, companies will be able to maintain control over their numbers; what they report will be what goes into the models
    - Improved ability of company to tell its own story
  - Improved integration of company operating and reporting data
    - As companies become more familiar with XBRL, the Committee believes it will be to their advantage to imbed the XBRL technology in an integrated manner into their databases to drive a variety of reports, of which the filed financial statements would be one set.
    - Operating data can be accessed in the internal enterprise applications where it is regularly stored, and thus used for financial reporting purposes without the necessity for downloading to paper or manual search
    - Same electronically accessible data can also be used for other purposes beyond those of financial statements, including tax, industrial filings, audit, benchmarking, performance reporting, internal management, and sustainability
    - Significant time and cost savings if integration is accomplished
    - The full economic benefits of XBRL for companies will most likely come when they incorporate XBRL in their internal reporting, instead of using it as a “bolt-on” after a company’s financial reports are prepared.

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<sup>26</sup> 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.

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- Benefits to users, including both retail investors and the “model builder/research analyst.”
  - Development of more easily accessed, reliable sources of relevant information – lowered cost of search will increase quantity and quality of analysis
    - Reduces the cost of inputting data into analytical frameworks
    - By eliminating manual input, reduces the likelihood of input error either by the user or the aggregator
    - Reduces user dependence on proprietary and inconsistent data sources
    - Increases the likelihood that more users will utilize the primary sources of data
    - Reduces the cost to compare companies and improves comparability
  - Potential to reduce analysts time and cost of coverage, and allow analysts to cover more companies
    - Potentially increases coverage, especially of small companies that now have no or limited coverage because of the costs of analysts’ time
    - Reduces time spent finding and keying data into analytical models
    - Reduces cost of re-distributing data provided by third-party data providers
    - Research organizations will be able to utilize their higher priced talent to spend more time in analysis rather than data gathering
  - Eases accessibility of the reported information for all investors and market participants
    - Analysts will see all of a company’s reported information, not just the information assembled and reported by aggregators
    - Eliminates time lag between the company filing its reports and analyst evaluation of the reported information
    - With simple search engines, all investors will be able to readily access all the information companies report.
    - Because of sharp reductions in costs of analysis, increases the likelihood that independent analysts will begin to offer their views to retail investors
  - Improves both analysis and dissemination of analysis to clients and others
    - Reported information goes directly into analysts’ models and is immediately accessible
    - Improves the efficient use of firm intellectual property for analysis and enables more rapid and effective collaboration/communication of these concept with clients
    - More information is contained in an XBRL report, lowering the cost of access for all reported information

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The Committee recognizes, however, that notwithstanding the potential benefits, many company officers may not understand how XBRL works or the improvements it would bring to both their financial reporting and their costs of reporting. In addition, there currently is limited acceptance of XBRL due, in part, to the following:

- Companies need greater certainty that XBRL will be adopted before they will expend the necessary resources to understand it and its benefits; and
- Companies may be concerned 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 are generally unaware or uninformed about XBRL.

### **Implementation of XBRL Tagging of Financial Statements**

The Committee believes, in conformity with the views of many preparers, users and auditors, that interactive data operating on an XBRL platform will offer significant benefits to public company preparers, users of public company reports, and the financial markets generally. XBRL has the potential to provide financial and non-financial information to the market in a way that is better, faster and cheaper than the current system, enhancing the availability, accessibility, consistency, and comparability of business information, together with cost-savings that will be of great benefit to companies, analysts, and investors alike.

The Committee believes that the SEC should eventually require all public reporting 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 the XBRL tagged information, use of XBRL tagged data by users such as analysts and investors, and company use of XBRL tagging internally. The Committee believes that full implementation of mandated XBRL tagged financial statements will require a phase-in over a period of time, as discussed below, to allow for enhanced understanding of XBRL by preparers and users, successful use of the new U.S. GAAP taxonomies, and further development of tagging and rendering software. The Committee believes that such a phase-in should be sensitive to the concerns of smaller public companies regarding mandated XBRL tagged financial statements.

The Committee believes 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.

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First, full mandatory implementation may not be possible until the following preconditions are met:

- Taxonomy development
  - Testing of taxonomies. The testing process for the new U.S. GAAP taxonomy, which is to determine that disclosures are complete and relevant in current market environment, is now underway
  - Release of the final U.S. GAAP taxonomy and preparer guide following public review and comment;
    - Successful use of U.S. GAAP taxonomy and preparer guide by voluntary filers for a period of time
    - Status: On December 5, 2007, XBRL published the draft of U.S. GAAP taxonomies and draft preparer’s guide for public testing and comment. The 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 taxonomy and preparer guidance will be issued in Spring 2008.
- Ability of SEC EDGAR to “seamlessly” accept XBRL submissions using the new U.S. GAAP taxonomy and other tagged 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 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 U.S. GAAP taxonomy.

Second, the Committee believes that, to achieve the desired acceptance of XBRL, on an interim basis XBRL tagged financial statements should be required to be implemented on a phased-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 with the voluntary program today, a document prepared separately from the reporting company’s financial statements filed as part of their periodic Exchange Act reports that contains the following:
    - XBRL tagged face of the financial statements;<sup>27</sup> and
    - Block tagged footnotes to the financial statements;<sup>28</sup> and

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<sup>27</sup> To allow this first phase, the SEC EDGAR system must permit submissions using the new U.S. GAAP taxonomies.

<sup>28</sup> The Committee understands 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.

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- 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.

The Committee believes that a phase-in would provide business, financial planners, software developers, and users the impetus to move forward in building systems based on XBRL. For example, in connection with the mandatory implementation of XBRL, the Committee is aware that, if mandated, preparers 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, the Committee believes 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. The Committee believes 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 U.S. GAAP taxonomies, 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 uniform taxonomies and preparer guidance to tag their financial statements.

In addition, as discussed under the phase-in approach described above, the XBRL tagged financial statements would still be considered furnished to and not filed with the SEC. As part of the mandatory implementation, the Committee believes that, as is the case in the voluntary program, the SEC should make clear what liability provisions the XBRL tagged financial statements would be subject to under the federal securities laws.

Third, at the end of the phase-in period described above, and as promptly as practicable after 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 official filing of XBRL tagged financial statements for domestic large accelerated filers, as well as the inclusion of all other reporting companies, as part of a company’s Exchange Act periodic reports.

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## **II.B. Developed Proposals**

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

Based on the above considerations, the Committee has developed the following proposal:

***Developed Proposal 5.1: The SEC should mandate the filing of XBRL-tagged financial statements within a defined time frame after certain preconditions relating to successful taxonomy testing and capacity of reporting companies to file XBRL tagged financial statements using the new U.S. GAAP taxonomy on the SEC's EDGAR system and for the EDGAR system to provide an accurate 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 with the voluntary program today, a document prepared separately from the reporting company's financial statements filed as part of their periodic Exchange Act reports that contains the following:***
  - ***XBRL tagged face of the financial statements;<sup>29</sup> and***
  - ***Block tagged footnotes to the financial statements;<sup>30</sup>***
- ***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; and***
- ***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 official filing of XBRL tagged financial statements 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.***

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<sup>29</sup> To allow this first phase, the SEC EDGAR system must permit submissions using the new U.S. GAAP taxonomies.

<sup>30</sup> The Committee understands 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.

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Questions for the Committee:

- 5.2) Should the SEC mandate the filing of XBRL tagged financial statements by all public reporting companies? If not, what should the SEC mandate to encourage the use of XBRL by public reporting companies?
- 5.3) If you agree that the SEC should mandate the filing of XBRL tagged financial statements, should the SEC follow the phase-in approach described above or should it instead mandate the filing of XBRL tagged financial statements as part of the official filing at the outset?
- (a) If you agree with the phase-in approach,
- (i) do you agree that the phase-in should begin with the 500 largest domestic issuers based on public float and then expand to include large accelerated filers?
- (ii) do you agree that the initial phase-in should mandate the tagging of the face of the financial statements and the notes on a “block” basis?
- 5.4) Are the preconditions described above necessary to be satisfied before the SEC should consider mandating the filing of XBRL tagged financial statements? If not, are there any preconditions that should be required to be satisfied?
- 5.5) Should the SEC commission studies or the development of software to assist preparers and users in tagging, rendering, and viewing XBRL tagged financial statements?

**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. The Committee understands that among the primary benefits in providing independent assurance of XBRL documents would be that financial statement users 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 users.

As to assurance, the Committee identified that questions arise as to whether assurance should be provided to:

1. determine if a company uses the proper XBRL taxonomy and accurately tags its financial statements;
2. assess the reasonableness of any company extensions to the XBRL taxonomy;
3. determine compliance with SEC content and format requirements;

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4. perform validation checks over footings and interchecks (for example, if inventory is reported more than once throughout the document, determine if amounts reported are consistent); or
5. determine if the information in the XBRL instance document is the same as the original filed document (applicable under a “bolt-on” state).

The Committee notes that there are ways that companies, mistakenly or deliberately, can create XBRL reports in a manner that will potentially mislead users. Accordingly, some Committee members believe 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 audit costs. They noted that accounting knowledge and professional judgment would be required in providing that assurance, but they believe that providing such assurance should not be an expensive or time-consuming activity, as many steps can be automated and other steps can be quickly and cost effectively embedded within existing audit methodologies and audit procedures.

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 money 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 can 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, other members of the Committee 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 with the SEC should take into account the needs of investors, companies, and other market participants and the costs to reporting companies. Until a group of reporting companies have been required to furnish to the SEC XBRL tagged financial statements and notes using the new 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 may be premature to make concrete suggestions regarding assurance. Accordingly, the Committee’s developed proposal does not include a specific 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 U.S. GAAP taxonomies, and related costs. Additionally, after public companies are required to tag their financial statements using XBRL, whether in

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accordance with the Committee's 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.

Questions for the Committee:

- 5.6) Do you agree that the SEC should implement a voluntary pilot program for companies to obtain assurance on their XBRL tagged financial statements to assess the costs and benefits of assurance?
- 5.7) Should the SEC mandate that companies receive assurance during the phase-in? If yes, what type of assurance should be provided? Should auditors be required to provide that assurance or may another third party be able to provide the assurance? If no, should there be another mechanism by which users can verify that the correct XBRL tags were chosen and that the XBRL tagged financial statements are the same as the underlying financial statements? Should management be required to provide a written certification that the company chose the correct XBRL tags for its financial statements, and, during a "bolt-on" state, the information furnished to the SEC agrees with the financial statements originally filed with the SEC?

### III. Improved Corporate Website Use

#### Background

The Committee has 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 such website presentations is that they often present the most important general information about the 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--if they wish--can follow a path into the details of the financial statements, the company's strategy and products, its management and corporate governance, and 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 the level of information about a company that 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 the needs of the particular shareholder or investor.

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Corporate websites provide 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.

The Committee has heard, 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, and the need for clarification of the public availability of information disclosed on a reporting company website. Consequently, the Committee believes that the SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information. The Committee believes that this 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, the Committee has developed the following proposal:

***Developed Proposal 5.2: The SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information addressing such issues as liability for information presented in a summary format, treatment of hyperlinked information from within or outside a company's website, and clarification of the public availability of information disclosed on a reporting company website.***

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*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.*

Questions for the Committee:

- 5.8) Does the Committee agree with the proposal that the SEC should issue an updated, comprehensive interpretive release regarding the use of corporate websites? Should the interpretation be limited or expanded in any manner?
- 5.9) Does the Committee agree that an industry developed set of uniform best practices is the right approach in encouraging greater use of corporate websites to inform investors and the market? If not, what alternatives can be proposed that would have such effect?

#### **IV. Use of Executive Summaries in Exchange Act Periodic Reports**

##### **Background**

The Committee has been exploring a requirement to include an executive summary in reporting company annual and quarterly Exchange Act reports (Forms 10-K and 10-Q). The Committee understands that a summary report prepared on a stand-alone basis would not necessarily provide investors information they need in a desired format. However, a 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 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 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 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 the companies' 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, 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

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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.

One alternative for such an executive summary in a periodic report would be that the summary should no more than 2 pages in length and should include the following:

1. Brief description of the company's business, sales and marketing;
2. Summary of a company's current financial statements;
3. A digest of the company's GAAP and non-GAAP key performance indicators (KPI's);
4. Summary of key aspects of company performance;
5. Summary of business outlook; and
6. References to more detailed information contained in the document, with page numbers.

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.

### **Future Considerations**

The Committee 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 quarterly report on Form 10-Q.

#### Questions to be Subsequently Considered by the Committee:

- 5.10) Do you believe the use of an executive summary as an integral part of a company's Exchange Act periodic report would contribute to an investor's ability to evaluate a company's disclosures?
- 5.11) Do you believe that an executive summary in an Exchange Act periodic report should be mandated or voluntary?

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## **V. Disclosures of Key Performance Indicators and Other Metrics to Enhance Business Reporting**

### **Background**

Enhanced business reporting and key performance indicators (KPIs) are disclosures about a company's business that is the source of its values. The Enhanced Business Reporting Consortium,<sup>31</sup> has stated that the value drivers for a business “can be measured numerically through key performance indicators 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 are supplemental non-GAAP financial reporting disclosures that proponents have stated can improve disclosures by public companies. Key performance indicators are leading indicators of financial results and intangible assets that are not encompassed on a company's balance sheet. Proponents of the use of KPI's 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. It has been stated that managers and company boards of directors 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.

### **Future Considerations**

The important issues for the Committee to examine are what types of KPIs should be made available, in what format, at what time, and whether they are clearly and consistently defined 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. The Committee will examine, among other matters, whether KPIs should be a voluntary or mandatory disclosure, 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. The Committee also will examine ways in which consistent KPIs can be developed through industry coordination.

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<sup>31</sup> 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.

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Question to be Subsequently Considered by the Committee:

5.12) Do you agree that the Committee should evaluate the increased use of key performance indicators and other metrics to enhance business reporting?

## **VI. Improved Quarterly Press Release Disclosures and Timing**

### **Background**

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

### **Future Considerations**

The Committee intends to review the press release for its consistency, understandability and its timeliness. The Committee will consider the consistent provision of income statement, balance sheet and cash flow tables in the quarterly release. It also intends 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, the Committee views the goal as a consistent, reliable communication form that all users can easily navigate.

In addition, based on anecdotal evidence and a survey of CFA Institute members, and consideration of comments received by the SEC when this idea was put forth in prior SEC rule proposals, the Committee will evaluate the advisability of the quarterly press release being put forth on the same day as the Form 10-Q is submitted, as opposed to the current lagged structure. The Committee will consider, among other things, (i) the savings in time spent cross-referencing two separate but fairly identical reports separated by a very short period and (2) the elimination of the concern that the two reports may not perfectly match.

The Committee does not intend to discuss the potential desire to do away with reporting quarterly results. Even though there is considerable concern that current financial reporting has a built in short term bias, eliminating quarterly reporting would likely lead investors to believe that they were being denied important guidepost information. The Committee elsewhere will focus on attempts to move corporate reporting in the direction of more fundamental and sustainable business measures which are often interpreted as having a longer term focus.

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Questions to be Subsequently Considered by the Committee:

- 5.13) Do you agree that the Committee should evaluate the content and timing of quarterly press releases issued by reporting companies?
- 5.14) Should the Committee evaluate other areas relating to quarterly press release disclosures?

**VII. Continued Need for Improvements in MD&A and Other Public Company Financial Disclosures**

**Background**

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

- to provide a narrative explanation of a company’s financial statements that enables investors to see the company through the eyes of management;
- to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
- to 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 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 the Division of Corporation Finance, that additional guidance was useful in the following areas:

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

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

**Future Considerations**

The Committee understands that investors and other market participants believe that while there has been some improvement in 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.”

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Under the Sarbanes-Oxley Act of 2002, the SEC is generally required to review every public company at least every three years. In that regard, the Committee believes that through the review process, the SEC will gain important insight on whether there has been improvement in company MD&A disclosures and the types of ongoing concerns regarding such disclosures. The Committee will be evaluating whether the SEC should periodically issue a report on common types of comments issued on MD&A and other financial disclosures similar to the Fortune 500 report to provide additional guidance on improving MD&A in accordance with the SEC's most recent interpretive guidance.<sup>32</sup>

Questions to be Subsequently Considered by the Committee:

- 5.15) Should the Committee encourage the SEC to periodically issue reports on common disclosure comments issued on MD&A and other financial disclosures?
- 5.16) Are there other steps the Committee would suggest be taken to improve the quality of MD&A disclosures?

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<sup>32</sup> The Committee notes 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.

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## APPENDICES

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Division of Corporation Finance  
U.S. Securities and Exchange Commission

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**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

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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

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## 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, to be presented either on a gross or net basis.

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- 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;<sup>33</sup> 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.

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<sup>33</sup> The estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economics and operating conditions.

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### 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, consolidation is required by the party that holds the majority of the voting interests, in effect, creating a bright line of 50%. 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*.

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- *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.

- *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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- *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

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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.

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- 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.

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