Introduction

Subsequent to the August 2, 2007 meeting of the SEC Advisory Committee on Improvements to Financial Reporting (Advisory Committee), committee members have formed four subcommittees to address the issues raised in Robert Pozen's discussion paper dated July 31, 2007 (Discussion Paper).

The attached report summarizes the efforts of the Substantive Complexity subcommittee thus far. At the November 2, 2007 full committee meeting, the subcommittee will present this report for discussion by the full committee.

Members: Susan Bies, Chair
Joseph Grundfest
Edward McClammy
Thomas Weatherford

Observers: Thomas Linsmeier, FASB (observer for FASB Chairman Robert Herz)
Charles Niemeier, PCAOB (observer for PCAOB Chairman Mark Olson)

Scope of Work Plan

Based on the Discussion Paper, the subcommittee identified the following areas for further deliberation:

- Industry-specific guidance
- Alternative accounting policies
- Bright lines and detailed guidance
- Mixed attribute model and the use of fair value
- Exceptions in GAAP other than industry-specific guidance
- Competing models[1]

In order to finalize the scope of its work plan, the subcommittee is in the process of developing a definition of "complexity" to serve as a guiding principle underlying the scope of the subcommittee's work plan and the nature of its recommendations for consideration by the full committee. The subcommittee notes that in certain

[1] Competing models are distinguished here from alternative accounting policies. The former refers to accounting models that are different, but not optional (e.g., different models for asset impairment testing such as inventory, goodwill, deferred tax assets, etc.). The latter refers to alternative accounting models that preparers are allowed to choose under existing GAAP (e.g., whether to apply the direct or indirect method of cash flows). The subcommittee intends to explore the role of the conceptual framework in future deliberations, in part as a cause of competing models.

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circumstances, complexity in financial reporting may be unavoidable due to the nature of business transactions. By defining complexity, the subcommittee seeks to identify and alleviate unnecessary complexity in financial reporting that undermines the communication of business transactions. The preliminary definition is as follows:

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

(1) preparers to communicate the economics of a transaction in accordance with generally accepted accounting principles,
(2) users to understand the economics of a transaction and the overall financial position and results of a company, and
(3) other constituents to audit, analyze, and regulate a company's financial reporting.

Complexity can impede effective communication through financial reporting between a company and its stakeholders, and creates inefficiencies in the financial reporting cycle (e.g., increased preparer, audit, user, and regulation costs).

Causes of Complexity

Significant causes of complexity, as opposed to the definition of complexity itself, include (not an all-inclusive list):

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

The subcommittee also intends to explore with various constituents of the financial reporting process (1) the preliminary definition of "complexity" and (2) the most pressing aspects of complexity that they believe should be considered.

Questions for the Full Committee:

1) Does the full committee agree with the subcommittee's preliminary scope? What areas, if any, would the full committee recommend adding or removing?

2) Does the full committee agree with the subcommittee's proposed definition of "complexity?" What revisions, if any, would the full committee recommend?

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Deliberations and Preliminary Hypotheses

Industry-specific guidance

The subcommittee's use of the term "industry-specific guidance" refers to (1) exceptions to general accounting standards for certain industries, (2) industry-specific guidance due to the lack of a single underlying standard or principle (e.g., industry-specific guidance on revenue recognition due to the lack of a generalized revenue recognition standard), and (3) industry practices not specifically addressed or based in GAAP. Industries covered by this guidance are far-reaching, including, but not limited to, insurance, utilities, oil and gas, mining, cable television companies, financial institutions, real estate, casinos, investment companies, broadcasters, and the film industry.

The subcommittee noted that industry-specific guidance has developed for a number of reasons, including:

- Numerous standard setting organizations.
- Desire by some to address and tailor required accounting to accommodate perceived special needs and desires of different industries (each industry believes it is unique).
- 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).
- Lack of overarching standards in certain areas of GAAP (e.g., a single comprehensive revenue recognition standard).

The subcommittee noted that industry-specific guidance contributes to complexity in the following ways:

- Increases the volume of literature. This volume, in turn, may result in:
  - Increased costs of implementing accounting literature.
  - Increased costs in maintaining accounting literature and standard-setting.
  - Increased costs of training accountants and retaining industry experts.
  - Complexity for users in understanding the variety of accounting and disclosure.
- Hinders more wide-spread use of XBRL, as it increases the number of different data tags that need to be created.
- May reduce comparability across different industries, if conflicting accounting models are used for transactions with similar or identical economic substance.
- May be used by analogy to either structure desired results or to require a more conservative answer (e.g., by auditors).

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- Requires analysis of whether a company is 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.

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

- May allow industry reporting to better meet the specific needs of the users of the financial statements in that industry.
- May result in comparability among entities within an industry.
- May reflect 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.
- Provides guidance where it is otherwise lacking in generalized GAAP.
- May simplify or reduce the amount of guidance a preparer in an industry would need to consider, even though it might increase complexity across industries generally.
- Evolution of accounting – may allow for issues to be addressed more timely. Specifically, industry-specific guidance may be easier to issue on an accelerated basis due to its narrower audience than that of generalized GAAP.

The subcommittee believes that a reduction in the amount of industry-specific guidance would reduce unnecessary complexity, even though it acknowledges that such guidance has merit in certain situations. The subcommittee believes that such guidance should be scoped and applied on the basis of business activities, rather than industries, particularly as many conglomerates cut across several distinct industries.

Based on the above considerations, the subcommittee intends to finalize the following preliminary recommendation for a future full committee meeting:

> ***Underlying principle: Similar activities should be accounted for similarly.***
>
> ***Preliminary Recommendation:***
>
> ***1) GAAP should be based on activities, rather than industries. Similarly, any exceptions included in GAAP should be based on activities, rather than industries.***
>
> ***2) The FASB should analyze all existing industry-specific guidance and determine whether, and the extent to which, it should be retained.***
>
> Possible justifications under consideration for retaining industry-specific guidance include:

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- The guidance addresses an activity whose economics is sufficiently dissimilar from other business activities.
- There is not an appropriate general standard that applies to the activity or transaction. However, in this case, the FASB should develop an appropriate general standard within a defined period of time to address the specific accounting activity (i.e., any existing or new industry-specific guidance should be phased out with sunset provisions).
- Cost/benefit considerations.

To facilitate this analysis, the FASB should use the FASB's codification project to divide 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

In developing its work plan, the FASB should consider opportunities in the context of its broader work plan to address these categories, with emphasis on category a. guidance first.

<u>Questions for the Full Committee</u>:

1) Does the full committee agree with the subcommittee's preliminary recommendation? What revisions, if any, would the full committee suggest?

<u>Alternative accounting policies</u>

Alternative accounting policies refer to optionality in GAAP. The discussion that follows relates to formally-promulgated options provided by GAAP (i.e., this discussion does not address choices available to preparers at more of a practice / implementation level[2]). 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) application of hedge accounting, and (c) the option to measure certain financial assets and liabilities at fair value.

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.

[2] 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.

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- Political pressure that results in standard-setters providing for a preferred and an alternative accounting method.
- Administrative convenience (e.g. cost-benefit considerations).
- A portrayal of differences in management intent (e.g., the accounting for certain investments in debt and equity securities as trading, available-for-sale, or held-to-maturity).

The subcommittee noted that alternative accounting policies contribute to complexity in the following ways:

- May result in lack of comparability amongst companies, as economically identical transactions are accounted for differently.
- May perpetuate substandard accounting, to the extent that alternative accounting policies result from political pressure.
- May lead to shopping by preparers for most favorable accounting treatment.

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

- May allow 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.
- May be developed more quickly than a final "perfect" standard, minimizing the effect of other unacceptable practices. In other words, alternative accounting policies may function as a short-term fix on the road to preferred/ideal accounting (evolution of accounting theory).

While the subcommittee believes that the elimination of alternative accounting policies would reduce unnecessary complexity, it acknowledges that such alternatives may have merit in certain circumstances. Accordingly, the subcommittee is in the process of developing the following preliminary recommendation for a future full committee meeting:

Preliminary Recommendation:

1) ***GAAP should be based on a presumption that formally promulgated alternative accounting policies should not exist, unless their presence can be justified.***

2) ***The FASB should analyze all existing alternative accounting policies and determine whether the optionality should be retained.***

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A number of possible justifications under consideration 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. Alternatives may, for example, differ based on their cost-effectiveness.
- The effect of applying the alternative policy not selected by the company can be clearly and succinctly presented, (i.e., either through financial statement presentation or footnote disclosure).
- 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).
- The provision of alternative accounting principles is coupled with a long-term plan to eliminate the alternative(s) through the use of sunset provisions.

As part of its deliberations, the subcommittee is specifically considering the application of this preliminary recommendation to alternative accounting that arises from management intent.[3] This is contrasted with other causes of alternative policies such as the administrative convenience of the preparer, compromises reached between competing constituent interests during the standard's development, etc.

The subcommittee is also considering the role of disclosures to ameliorate the tension created by the choice of one alternative at the expense of another. If companies continue to be afforded a choice, they could be required to clearly and succinctly present the alternative(s) that was (were) not selected (i.e., either through financial statement presentation or footnote disclosure) .

<u>Questions for the Full Committee</u>:

1) Does the full committee agree with the subcommittee's preliminary recommendation? What revisions, if any, would the full committee suggest?

<u>Bright lines and detailed guidance</u>

Bright lines refer to two main areas: quantified thresholds and pass/fail tests. Quantified thresholds range from hard-and-fast cutoffs to rules of thumb or presumptions coupled

[3] 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 its investment. The financial statement treatment differs for all three categories.

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with additional considerations. For example, GAAP requires that leases 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, be classified as capital leases and recognized on the lessee's balance sheet. Pass/fail tests refer to situations where a transaction (or the timing of a transaction) is completely reflected in one way or another, rather than proportionally (i.e., somewhere along a spectrum rather than on an all-or-nothing basis). For example, software revenue recognition guidance defers the timing of recognition of all revenue in situations where vendor-specific objective evidence (VSOE) of fair value does not exist for all of the undelivered elements of a software sales contract, until sufficient VSOE does exist or delivery occurs.

Detailed guidance relates to what is commonly referred to as rules, in contrast to principles. As an example, the accounting for derivatives is often described as rules-based, in light of the hundreds of pages of guidance to explain the principle that derivatives should be accounted for at fair value, with changes in fair value recognized in earnings, except for instruments designated as and qualifying as effective hedges.

Bright lines and detailed guidance arise for a number of reasons, including:

- An effort to drive comparability amongst companies (e.g., the application of VSOE in determining revenue recognition for software companies).
- Convenience for preparers, auditors and regulators, in that 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.
- The lack of a single, underlying principle.
- Requests for additional guidance on exactly how to apply the underlying principle. These requests often arise out of fear on the part of preparers and auditors of using judgment that may be second-guessed by inspectors, regulators, and the trial bar.
- Efforts to curb abuse.

The subcommittee noted that bright lines and detailed guidance contribute to complexity in the following ways:

- May result in accounting that is not representationally faithful to the economic substance of the arrangement.
- May reduce comparability, as two economically similar transactions may be accounted for differently (e.g., a lease arrangement where the present value of minimum lease payments is 89% of the fair value of the leased property vs. one at

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90% of the fair value are virtually economically identical yet accounted for in a drastically different manner).

- Creates opportunities for structured transactions to achieve a specific accounting / reporting result (e.g., in lease accounting and hedge accounting whole industries have been developed to create structures that work around the rules).
- Requires additional guidance to curb abuse from structured transactions developed to work around the rules and to address circumstances that do not result in meaningful financial reporting of the economic substance of transactions to investors.
- Requires expertise to account for certain transactions given the volume of guidance, which increases the cost of accounting and the risk of restatement.

On the other hand, the subcommittee noted that bright lines and detailed guidance may alleviate complexity in the following ways:

- May reduce judgment, which may limit aggressive accounting policies.
- May enhance perceived comparability amongst companies.
- Convenience – see discussion above.
- Evolution of accounting – where no underlying standard exists, bright lines and detailed guidance may be used to limit the application of new accounting guidance to a small group of companies. 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 preferred/ideal accounting.

The subcommittee believes that the principles vs. rules dichotomy is a specious debate and that certain circumstances require more guidance than others. The subcommittee will seek to define these circumstances. The subcommittee noted that even if the FASB and SEC limited issuance of bright lines and detailed guidance, audit firms and other parties would likely create non-authoritative guidance anyway. Any recommendations to limit bright lines and detailed guidance would require a cultural shift towards acceptance of more judgment. Accordingly, the subcommittee intends to follow the efforts of the Audit Process and Compliance subcommittee's deliberations of a professional judgment framework and the Standard Setting subcommittee's deliberations of the proliferation of interpretations. This will assist the subcommittee in development of a potential recommendation with respect to bright lines and detailed guidance.

In addition, the subcommittee is considering recommending the use of pro rata accounting (e.g., leases could be proportionally reflected on balance sheet, rather than completely on or off balance sheet) and rules of thumb coupled with additional considerations, as alternatives to replace the use of bright lines, to account for transactions based on their economic substance. The subcommittee has yet to define the

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possible scope of pro rata accounting, but it may extend to areas such as leases, consolidation policy, and off-balance sheet activity.

Question for the Full Committee:

1) Does the full committee agree with the direction of the subcommittee's efforts thus far regarding bright lines and detailed guidance? What revisions, if any, would the full committee suggest?

Mixed attribute model and the use of fair value

The mixed attribute model is one where the carrying amounts of some assets and liabilities are measured based on historical cost, some at lower of cost or market, and some at fair value. This complexity is exacerbated by the recognition of some adjustments to carrying amounts in earnings and others in comprehensive income. Some have advocated mandatory and comprehensive use of fair value as a solution to the complexities arising from the mixed attribute model.

The subcommittee noted that the use of fair value may contribute to complexity in the following ways:

- Understandability
  - 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.
- Reliability, auditability, and quality of fair value estimates
  - Some argue that too much judgment is necessary in developing fair values and that many of the inputs are not easily verifiable. These factors significantly impact the auditability of the numbers.
  - Preparers are concerned with second guessing from auditors, regulators, and civil litigation, which is compounded by management certification requirements.
  - The quality, skill, and reports of valuation specialists vary greatly. Preparers have limited ability to assess this variety. Further, there is no licensing mechanism to ensure ongoing quality, training, and oversight of valuation specialists.
- Financial and other costs

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- Some preparers' knowledge of valuation methodology is limited, requiring the use of valuation specialists, which results in additional expenses.
- 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.
- Preparers view disclosure of some of the inputs to the assumptions as sensitive and competitively harmful.

- Requests for detailed guidance and exceptions
  - 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.
  - There is no single set of generally accepted valuation standards for financial reporting purposes. Consequently, some have argued for additional, uniform guidance.

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

- Considered more relevant in many cases as historical cost is not meaningful for certain items.
- Helps to prevent some transaction structuring.
- Helps to achieve consistency.
- Would provide users with the same information as management, to the extent management makes decisions based on fair value.
- Alleviates issues related to the mixed attribute model, including addressing issues arising from measurement mismatches and the need for detailed application guidance explaining which instruments must be recorded at fair value.
- Would eliminate certain issues surrounding management's intent (e.g., when evaluating whether to write down the carrying value of certain investments in debt and equity securities, there would be no need to assess whether the holder has the intent and ability to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value, as all financial instruments would be carried at fair value with changes flowing through earnings).

The subcommittee acknowledged the numerous implementation issues surrounding the use of fair value, such as the potential need for additional standard setting and a regulatory body overseeing valuation specialists. However, the subcommittee determined that, in light of the duration of the Advisory Committee, the mandate to develop do-able recommendations in the short-term, coupled with the developing nature

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of the valuation industry environment, it would focus its recommendations on broad concepts rather than specific implementation guidance.

Accordingly, the subcommittee intends to continue to explore the following preliminary hypotheses for a future full committee meeting:

1) Decision framework – The subcommittee intends to further understand the FASB's conceptual framework project and consider recommending that, as part of this project, the FASB should develop a decision framework to provide a systematic approach for determining the most appropriate measurement attribute for various assets and liabilities based on consideration of the trade off between relevance and reliability, and the various constituents involved in the financial reporting process.

2) Moratorium – Due to implementation complexities, as noted above, the subcommittee 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 decision framework. The subcommittee 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.

3) Grouping by Measurement Attribute – 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 subcommittee is considering whether the FASB should require further groupings based on an internally consistent measurement attribute.

4) Multiple Performance Measures – The FASB has also tentatively decided, as part of its financial statement presentation project, 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. The subcommittee intends to further study this project and consider whether it would facilitate users' understanding of fair value. As an alternative, the subcommittee will also explore the notion of presenting the income statement in two parts: a core earnings measure comprised of items within management's control and a measure of all other items outside of management's control.

5) Disclosure Framework – The subcommittee has identified potential areas for additional disclosure not necessarily required by current GAAP (e.g.,

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disclosure of statistical confidence intervals associated with certain valuation models, which Statement 157 does not currently require). Consequently, the subcommittee is considering recommending that the FASB develop a disclosure framework that more effectively signals to users the level of uncertainty associated with fair value measurements (the subcommittee 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 for additional disclosure include the valuation model, the entity's position vs. that of the entire market, the magnitude of variance around the recognized mean, sensitivity analyses, and key assumptions. The subcommittee acknowledges uncertainty also exists in other measurement attributes, such as historic cost, which may warrant similar disclosure.

To minimize the effect of diminishing returns on potential new disclosure improvements identified during the course of Advisory Committee's efforts and future standard-setting activity, the subcommittee is considering recommending that the disclosure framework, more broadly, integrate existing disclosure requirements into a cohesive whole (e.g., eliminate redundant disclosures and provide a single source of disclosure guidance across all accounting standards), and perhaps referring this issue to another subcommittee.

6) Tiered audit opinion – The subcommittee also deliberated a recommendation for auditors to issue a tiered audit opinion, which would provide varying levels of attestation based on the inherent uncertainty of a measurement. The subcommittee considered this recommendation in light of concerns over the gap between the actual and expected assurance from auditors and auditors' potentially inherent inability to audit fair value due to its subjectivity and auditors' lack of first hand knowledge about an entity. The subcommittee concluded this area would be best considered by the Audit Process and Compliance subcommittee.

7) Hedge accounting – The subcommittee considered complexities arising from the application of hedge accounting. It noted that in certain situations, hedge accounting allows entities to mitigate reported volatility over the life of the hedge relationship, consistent with management's intent to economically hedge its exposures over a specified term. As a result, the subcommittee tentatively agrees that it should be simplified rather than eliminated. In this regard, the subcommittee is debating a recommendation to eliminate the requirement to assess hedge effectiveness and instead, record the ineffective portion in earnings (i.e., a pro rata approach versus an all or nothing

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approach). The subcommittee is also monitoring the FASB's derivatives project and will consider the effects of this project on its recommendation.

Questions for the Full Committee:

1) Does the full committee agree with the subcommittee's intention to refrain from deliberating implementation issues and to, instead, focus on broad concepts?

2) Does the full committee agree with the subcommittee's direction regarding measurement, disclosure and hedge accounting? What changes, if any, would the full committee suggest?

Current Status and Further Work

The subcommittee expects to finalize its recommendation regarding industry-specific guidance and alternative accounting policies for the January 2008 full committee meeting.

The subcommittee expects to undertake the following in subcommittee meetings following the January 2008 full committee meeting:

- Finalize its scope, including its definition of "complexity."
- Continue discussions regarding (a) bright lines and detailed guidance and (b) the mixed attribute model and the use of fair value.
- Commence discussions regarding other exceptions, competing models and the conceptual framework.

Coordination with Other Subcommittees

The subcommittee wishes to refer consideration of a tiered audit opinion, as discussed above, to the Audit Process and Compliance subcommittee.

The subcommittee also wishes to refer any transition issues created by its potential recommendations regarding industry-specific guidance and alternative accounting policies to the Standard Setting Process subcommittee.

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