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RECORD OF PROCEEDINGS OF

SEC ADVISORY COMMITTEE ON IMPROVEMENTS
TO FINANCIAL REPORTING
OPEN MEETING

Friday, November 2, 2007

9:30 a.m.- 3:00 p.m.

United States Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C.

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COMMITTEE MEMBERS PRESENT

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Robert Pozen, Committee Chairman

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Dennis R. Beresford

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Susan Schmidt Bies

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J. Michael Cook

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Jeffrey J. Diermier

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Scott C. Evans

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Linda L. Griggs

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Joseph A. Grundfest

12

Gregory J. Jonas

13

G. Edward McClammy

14

Edward E. Nusbaum

15

James H. Quigley (by telephone)

16

David Sidwell

17

Peter J. Wallison

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Thomas Weatherford

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COMMITTEE MEMBERS ABSENT

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Christopher Liddell

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William H. Mann, III

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OFFICIAL OBSERVERS PRESENT

Robert Herz
Charles Holm
Kristen Jaconi
Philip Laskawy
Mark Olson

SEC AND COMMITTEE STAFF

Conrad Hewitt, SEC Chief Accountant
Jim Kroeker, SEC Deputy Chief Accountant
Russell Golden, FASB Senior Advisor to Committee Chairman
John White, SEC Director of Division of Corporate Finance

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P R O C E E D I N G S

1
2 MR. KROEKER: I'll open the meeting formally and thank
3 everyone for attending. For those in the audience, there are
4 papers available - the discussion papers. They look like
5 this thing here. If you don't have it already, there are
6 copies available.

7 I would also like to thank the people who are
8 participating via webcast. And, for those, the discussion
9 papers for today are available online, so you can follow
10 along in the discussion.

11 With that, I will turn it over to Conrad to make
12 some introductory remarks.

13 MR. HEWITT: Good morning, everyone. On behalf of
14 Chairman Cox and the rest of us at the SEC, we welcome you to
15 your second open hearing.

16 We know also that, for the last two months, the
17 four subcommittees have been working very diligently on
18 various topics, and we look forward to your deliberations on
19 those topics today.

20 At this time, the meeting has been formally opened
21 by our designated federal officer, Jim Kroeker, so, Mr.
22 Chairman, I'll turn it back to you.

23 MR. POZEN: Well, thank you very much. We
24 appreciate all the work of the members of the committee. I
25 think there has been a huge effort to really bring things

1 forward. And we also appreciate the staff leadership of Russ
2 Golden and Jim Kroeker and then all the other people who have
3 been involved.

4 I think, if we turn to this book, to the agenda on
5 the first page, I'll keep my introductory remarks very short.

6 Basically, the point of this meeting is twofold.
7 One is to have the various subcommittees report as to the
8 work they have been doing over the last few months. And
9 then, second of all, is to get some sense of where these
10 subcommittees would be going between now and the next public
11 meeting, which will be, I think, January 11th.

12 So those are the purposes. And the way we will
13 proceed is to have each subcommittee, starting with I, moving
14 to II, III, and IV, in logical order, make a short
15 presentation of the issues, which will follow this book, and
16 then we really are hoping to have some very good discussion
17 from the other members of the committee, so we can reach a
18 consensus on some of these issues.

19 I think the next matter on the agenda is review of
20 the comment letters received. These are at the back of the
21 book. I think these are - sorry, they are not at the back
22 of the book. They are posted on the Web. They are posted on
23 the Web, and I think they have been disseminated to all the
24 committee members.

25 And I guess I would say that we have taken the

1 input of these various comment letters and, unless someone
2 has a question about the comment letters, I was going to go
3 on to have the reports of the subcommittees.

4 So are there any questions about any of the comment
5 letters?

6 MR. POZEN: Okay. I think we should emphasize
7 that, in 2008, the full committee will hold meetings in San
8 Francisco, New York, and Chicago, in which case, we will take
9 testimony, and various groups will have a chance to present
10 their views.

11 And also, a number of the subcommittees have
12 solicited input from various people in the financial
13 industry, and in auditing, and in various other groups, so
14 that we are in the process, not just through the comment
15 letter process, but through actual testimony and discussions,
16 of really making a big effort to canvass what is out there
17 and what people's views are.

18 MR. KROEKER: There is also an open box on the web
19 site, or an open link, for anybody that wants to provide
20 comments at any point in time.

21 MR. POZEN: Okay. So, without further ado, I'm
22 going to ask the subcommittee chairman, Sue Bies, from
23 Subcommittee I - Subcommittee I is looking at the area of
24 substantive complexity. And just to give you an overview,
25 Subcommittee II is looking at the process of standard

1 setting. Subcommittee III is looking at audit compliance and
2 restatements. And Subcommittee IV is looking at information
3 delivery, including XBRL and summary documents.

4 So this first presentation will be on the area of
5 substantive complexity. So, Sue, if you wouldn't mind
6 leading off.

7 MS. BIES: Thank you, Bob.

8 Well, the first subcommittee, given we're trying to
9 deal with what is complexity, we are going to tee up the
10 discussion on these various things and try to, really,
11 approach it, initially, around two issues.

12 Number one, what do we mean by complexity? And we
13 are going to talk about that first in the summary.

14 And second, then, given that definition, what are
15 the key drivers that are creating complexity, and what can we
16 do to address any of those specific issues?

17 And we have already sort of keyed up four broad
18 areas that we believe are part of the problem with
19 complexity. And we also identified some areas where there is
20 an overlap with some of the other subcommittees, and we will
21 be mentioning those as we go along to encourage our fellow
22 committee members of the big committee to continue to pursue
23 some of these other issues.

24 So let me first put to the full committee the issue
25 of complexity. As you can see, on page 2 of our summary, we

1 have sort of teed up an initial definition, and we would like
2 to get the full committee's feedback on this to start.

3 Let me just sort of talk about the different
4 points. We think that complexity has to be viewed from both
5 the preparer's side, as well as the user's side, and then
6 also thinking about the auditability of any accounting
7 standard, and if it is difficult to prepare statements or to
8 understand the transactions, whether they really reflect the
9 business economics - that that is an issue.

10 We want to make sure that the accounting principles
11 really clearly demonstrate why transactions happened, in
12 terms of the results of those transactions.

13 So what we want to do is think about the causes of
14 complexity. And we know that some of them are due to the
15 complexity of business transactions themselves. They have
16 gotten more difficult. More things are being bundled, more
17 things are being structured, and it's the complexity of the
18 underlying business that creates some these problems, so that
19 preparers are trying to decide what accounting standard is
20 the appropriate one to follow.

21 Given the environment that we have been in in the
22 last several years - and, clearly, in the last couple months
23 -- there is also this fear of being second-guessed, because a
24 lot of what we are moving toward is more of a mark-to-model
25 kind of framework in some areas, and all of the reserving,

1 all of the accrual, all of the fair value kind of issues
2 create some second-guessing risk for companies.

3 We also know that there is structuring that goes
4 on, where people will do a deal in order to achieve a certain
5 accounting result, and that can create complexity in and of
6 itself and, clearly, for users of financial statements, can
7 obscure the real risk of business results.

8 And then, finally, the last one - and this one
9 overlaps with another subcommittee - is just the vast number
10 of accounting standards that are out there that, both formal
11 and informal, multiple bodies that have issued them. And we
12 would really encourage the FASB and all of the other bodies
13 to be - and the other subcommittees who touch on this - to
14 really, at a minimum, get a codified set of accounting
15 standards, so someone can go and look by topic and find out
16 what is the relevant literature because, given the vast
17 amount out there, some of it informal, through speeches -
18 say, by SEC staff members, and so on - it makes it difficult
19 to know what the appropriate accounting is.

20 So, at a minimum, we would hope that gets
21 addressed, in terms of a process, along the way.

22 Let me sort of start with just feedback from the
23 general committee. Do you think, given our initial scope and
24 the initial definition of complexity, are we headed in the
25 right direction? Is this the way you would expect our

1 subcommittee to proceed? Are we teeing up the right issues?

2 MS. GRIGGS: Sue, it's Linda. I think you are
3 teeing up the right issues.

4 The one area that I thought I would have expected
5 to see in the definition and in the causes of complexity was
6 just the difficulty of fair-valuing non-traded assets and
7 liabilities. And I'm wondering if you gave consideration to
8 that and whether that would fit. And I think it could fit
9 into your definition of the causes.

10 MS. BIES: We have talked about it a bit as we have
11 started to discuss fair value issues, but you're right, we
12 didn't capture that probably in the definition, and we should
13 bring that forward. I think that's a good suggestion.

14 MR. DIERMIER: Sue, this is Jeff. I think you have
15 captured the scope very nicely, as well.

16 I would just - in the area of causes of
17 complexity, I think it might be good if there was an addition
18 that would address the fact that an additional cause,
19 basically, comes from the standpoint of the investors,
20 themselves, that multiple choices, difficult navigation, and
21 changing accounting treatments, lack of clarity between
22 operating and investing results, lack of segments, difficulty
23 in comparing - this is an important element of complexity,
24 as well. So it's complexity, certainly, for the preparers,
25 but also for the users, as well. I think that would be my

1 suggestion.

2 And then a really small nit. But I've been
3 spending some time trying to understand - we all know what
4 second-guessing means, right? But, obviously, it's okay for
5 people to ask questions. So is that second-guessing? So if
6 the group might think a little bit more about what the
7 fundamental underpinning of second-guessing is, that might be
8 helpful to, I think, all the parties involved.

9 MR. EVANS: I wanted to tag on to Jeff's comments
10 because I think perspective of users - who are, after all,
11 the ultimate beneficiaries of financial statements - needs
12 to come through in a little bit more strong fashion, so that
13 it's not - there's an awful lot of focus on the perspective
14 of the preparers and the auditors, but if financial
15 statements are not useful to the users, if they are not
16 understandable to users, they fail on a number of levels. And
17 it's the real cause of the complexity.

18 MR. POZEN: Yes, Greg?

19 MR. JONAS: Sue, this is Greg. Two thoughts.
20 First, I thought the scope was very appropriate. I would
21 encourage us to think about one item that perhaps is here and
22 I didn't focus on it enough, but if it's missing, I would
23 encourage you to work at it, and that is the whole notion of
24 simplicity of communication of expression of planning, which
25 I think is a real barrier to users of understanding

1 the information.

2 I contrast, in face-to-face meetings with
3 management, the clarity of communications - the graphs, the
4 charts - I contrast that to what I think is often a very,
5 very needlessly complex way of communicating in the formal
6 filings. Some progress - the Commission did some wonderful
7 work on financial reporting a few years back, and I think
8 some of those concepts could - we could bring forward and
9 emphasize.

10 A second concept doesn't relate directly to the
11 agenda but, rather, how we tee up the entire issue of
12 complexity. And I really like the way that you have
13 identified the various players in the process and how
14 complexity relates to each, but some solutions to the
15 complexity problem serve only to transfer complexity from one
16 constituency to another. And our challenge, I think, is to
17 find solutions that actually take out complexity for all
18 constituencies and not just transfer it.

19 Let me just - my favorite example is the grand
20 debate over principle-based standards versus rules. You
21 know, the soft underbelly of principle-based standards is
22 boundless judgment. And boundless judgment might really, you
23 know, reduce complexity for those who prepare financial
24 statements, but it certainly does make life miserable for
25 those who are trying to compare one company against another.

1 It's just a transfer of complexity that really doesn't make
2 our lives easier.

3 MR. GRUNDFEST: Just a brief observation. In our
4 conversations on complexity, we actually did have one simple
5 observation, and that is there are, at least, two kinds of
6 complexity.

7 First, the real world is complicated. And there is
8 a sense in which, if you try to take the real world, which is
9 complicated, and present it in a simple depiction, you lose a
10 certain aspect of representational fidelity. So there is a
11 level of complexity which is necessary, if you are going to
12 maintain fidelity. And, at a certain point, trying to impose
13 simplicity really goes against the objective of fidelity.

14 Second, I think it's important to recognize that
15 accounting rules and regulations can create unnecessary
16 complexity. So, for example, when you've got a set of bright
17 line rules - and let's bring it home to an issue that
18 everybody is concerned about today.

19 Let's say, if you structure a SIV the following
20 way, you can keep it off your balance sheet and you don't
21 have to take a capital gain per Basel accounting standards.
22 Then you're going to have everybody structure SIVs right up
23 to that line, so they keep it off their balance sheet, and,
24 there, you've got a set of complexity that is actually
25 artificially induced into the financial system as a result of

1 the reporting rules and regulations we have.

2 One of our observations is that you can and should
3 think about ways of reducing the induced complexity - the
4 complexity that regulators actually drive into the financial
5 process - and then increase the mechanisms for accurately
6 describing the innate complexity - which comes about, you
7 know, when you invent Black-Scholes pricing, and, now, you
8 can do things with derivatives, and you're doing it
9 intelligently and not for regulatory reasons.

10 MR. POZEN: Well, I think that probably we have
11 pushed this as far as we can. This complexity definition is
12 the sort of thing that is very complex in itself.

13 And I think that I would like to ask Sue to move on
14 to - there are three or four more specific issues which the
15 subcommittee has been looking at. And I think the first one
16 has to do with industry-specific guidance, which is a very
17 concrete example of unnecessary complexity. And we might
18 focus on that. Thank you.

19 MS. BIES: Thanks, Bob. There is two issues that
20 -- as you can see by our summary of our deliberations so far
21 -- on industry-specific guidance and alternative accounting
22 policies that we think are examples of some of the complexity
23 that is out there.

24 And, when we look at them, what they do is,
25 basically, provide multiple ways to account for the same

1 economic transaction. And, to the extent that part of our
2 definition of complexity is to have multiple ways to account
3 for the same transaction, we teed up these two issues fairly
4 quickly.

5 I want to emphasize here that, when we talk about
6 the same economic transaction, we mean business transaction,
7 not asset or liability, to the extent that an asset or
8 liability can be used in different ways in different
9 businesses and different types of transactions. So we are
10 really defining this around activities.

11 And so, for example, when we see the term
12 "industry-specific guidance," part of the confusion is: Are
13 you primarily in that industry? Or are we really talking
14 about a type of activity which you might find in a certain
15 group of firms more than others, but if that same economic
16 business activity occurs in another company in a minor way,
17 shouldn't you follow the same accounting?

18 So, as we have teed this up, we are really talking
19 about the substance of a business activity being the same,
20 but having the potential for being accounted for in two
21 different ways. And we think that that, in and of itself, is
22 something that should be clarified by standard setters, given
23 the nature of the change in business going forward.

24 So let me talk about industry-specific guidance
25 and tee up the key issues here.

1 In some ways, some of this came about because
2 specific industries felt they were unique and heavily lobbied
3 the appropriate regulatory bodies and standards setters for
4 their uniqueness and unique accounting. Sometimes, it's a
5 practical issue, in that some new business practice has
6 arisen, and trying to get something out the door quickly for
7 preparers to follow doesn't give the standard setter a chance
8 to explore the whole realm of possibilities or related
9 transactions.

10 We think that we should - whenever there is more
11 than one potential out there, what we are initially thinking
12 about is it should be clear that this is a placeholder; that
13 this is there as an interim measure until the whole area can
14 be scoped out and decide whether this is just to clarify
15 something in the interim, and it will be scoped into
16 something bigger down the road.

17 To have multiple types of accounting can be very
18 difficult in the long run, but we can see a cost benefit
19 sometimes in the short run. And determining where that
20 trade-off occurs is one of the issues that we're going to
21 have to wrestle with as we think about this cause of
22 complexity.

23 Maybe I'll pause there, just -

24 MR. POZEN: I just think we should just clarify to
25 focus the discussion. There are two sort of related issues

1 here.

2 One is whether we should continue to have
3 industry-specific accounting standards, or whether we should
4 shift to activity-based.

5 And the second is, in those areas where, as you
6 say, there are alternative standards, whether there is an
7 adequate justification for alternative standards.

8 And, as you can see from the paper, we are
9 proposing in both cases that there be a presumption against
10 industry-specific standards and a presumption against
11 alternatives. But we recognize that there could be
12 circumstances where these are justified, and we ought to
13 recognize - and I'll say this, you know, as a member of one
14 industry - every industry is going to think they are unique,
15 so this would be quite a dramatic proposal.

16 And the same thing with alternatives. Those
17 alternatives, many of them came about because people pushed
18 pretty hard for them.

19 So recognizing the political realities, we would
20 still want to see if we could get to the right conceptual
21 place and then think about - and that would be our general
22 rule, and then, essentially, have really good reasons to
23 deviate from that.

24 So I think this is all laid out pretty well in the
25 book, but I think these are quite important issues, and I

1 would like to get some - there are two separate issues, but
2 they are parallel, and I would like to get some input from
3 the full committee.

4 MR. SIDWELL: Well, I would make the observation
5 that, in terms of industry-specific, I think one of the
6 things that the subcommittee chose to look at is the question
7 of field-testing to get a better understanding of the
8 applicability of standards to preparers, auditors, and users
9 of the standards.

10 I think that one of the things that can be done
11 going forward is by placing more emphasis on the need to do
12 field-testing of the cost benefit analysis, so that you can
13 better understand what are the valid differences and unique
14 characteristics of certain industries that should be
15 considered in providing a standard.

16 So I do think that we can view this as part of the
17 overall emphasis on making sure that we understand what the
18 activity is. And I think that can be driven through good
19 field-testing to understand all the nuances you would have to
20 consider in defining the standard.

21 MR. POZEN: Yes, Bob?

22 MR. HERZ: I gave a series of speeches on this
23 topic last spring. And I think I came to the same conclusion
24 that your committee is coming to, but I did have the - there
25 were some people in the investment world who said, you know,

1 "We follow a particular industry. We understand what they
2 do. Don't mess around with it."

3 For example, we have a large project on revenue
4 recognition, which aims at getting at one or a handful of
5 models - conceptual models that could be applied across all
6 sorts of activities, industries, and the like, but it would
7 have a common conceptual underpinning.

8 And that's very attractive, if you believe that
9 that is what investors ultimately would want versus people
10 who follow a particular industry and say, "I already
11 understand what they do. It may be slightly different for
12 the same thing in another industry, but I follow that
13 industry. I already understand it."

14 So I would be very interested in that topic and
15 understanding kind of what investors really think the
16 ultimate objective should be.

17 MR. POZEN: I think one thing that was discussed
18 with the subcommittee is, with a lot of companies - a good
19 example being financial services - being in a variety of
20 activities, the use of the industry category may, in itself,
21 raise a lot of definitional issues. And the subcommittee was
22 trying to get toward a notion of if it's more important what
23 the activity is than what the entity was.

24 Charles?

25 MR. HOLM: I would like to comment on this from a

1 perspective of a bank regulator. I certainly think the
2 recommendations, you know, overall are sensible. I certainly
3 can't argue that, just because an activity is in a different
4 industry, that it, therefore, should be accounted for
5 differently. Obviously, we would want similar accounting
6 across industries.

7 At the same time, I want to be careful about maybe
8 being too negative about industry guidance because, in many
9 cases, I think what it tries to do is just explain GAAP in
10 the context of the specific transactions of that industry,
11 and it's sort of like the squeaky wheel gets the grease.

12 I think, often, you know, Bob Herz and Con Hewitt
13 and all are focused on much bigger picture issues, and that's
14 what they should be, and they can't deal with every, you
15 know, nitty-gritty sort of industry issue along the way, but
16 there can be cries for that kind of guidance.

17 One other thing I want to say, too, is that bank
18 regulators - we often issue guidance. Now, I would not view
19 our guidance as being industry-specific guidance in the
20 context of GAAP that - we don't set GAAP.

21 What we do is issue guidance that affects the
22 prudential or regulatory boards that banking organizations
23 need them to file with us, and we find that guidance very
24 helpful because it creates much more comparability over
25 reports and allows us to make automated information, and what

1 have you.

2 But what happens is, when we issue that guidance -
3 and we think, largely, this is a good thing - that guidance
4 often becomes de facto GAAP. That is, institutions, they
5 want to file direct reports and have similar type of
6 information in their SEC reports. So, effectively, what we
7 say gets applied in their SEC report.

8 So I still think you're going to have this issue,
9 even if you reduce the so-called authoritative industry
10 guidance.

11 MR. POZEN: I think you make some good points. I
12 just would sort of urge you to page 5, where I think there is
13 an effort at the top to say there are certain industry guides
14 that may just be elaborating and detailing GAAP, and those
15 would be, I think, acceptable.

16 But there are those that are actually in conflict
17 with generalized GAAP, and I think those are the ones that
18 are the most problematic.

19 There are also areas in which there is no
20 generalizable GAAP, and so there's sort of a vacuum.

21 So those are three very different categories. I
22 think, to the extent that, whether it's the bank regulators
23 or anyone else would sort of be on the same wavelength with
24 GAAP but elaborate it and give more specific guidance - I
25 guess to the extent that - it's a Subcommittee II issue that

1 we can get that process right.

2 That's not an issue. But I think there are quite a
3 few examples in which there are either outright conflicts or
4 there are areas where the lack of a general standard - like
5 revenue recognition - has led to tremendous disparity. And
6 I think it's those areas that we are trying to focus on. And
7 I don't think the subcommittee was intending to try to
8 eliminate all guidance in particular industries.

9 MR. HOLM: I agree.

10 MS. GRIGGS: I don't disagree with these two
11 recommendations. I just wonder whether they are priorities.
12 I think there are some other issues that you have teed up
13 that I would think would be ones that we should focus on
14 first, rather than these two, because my sense is that these
15 two have not been big problems and that, perhaps, on an
16 interim basis - you know, I think the industry-specific
17 recommendation will require an enormous amount of work, and
18 perhaps we can focus on other areas that will give us some
19 progress in producing and improving financial reporting more
20 quickly.

21 And on sort of an interim basis, I do think perhaps
22 disclosure about alternatives and the alternative area may go
23 a long way to alleviating some of the concerns about those
24 differences.

25 MS. BIES: If I could just respond. I think what

1 we were trying to do - at least, at this stage in our
2 subcommittee - is we were trying to both think about the
3 broad issues and where we want to go, but also try to get to
4 maybe a couple narrowly-defined specific issues, where sort
5 of a quick conclusion could be reached that could maybe lay
6 out some principles for the more complex issues that we are
7 still really wrestling with.

8 And in both the industry-specific and alternative
9 accounting policies, what we felt is here is something where
10 we think there are some clear principles that could be laid
11 out.

12 And so I don't want, by the priorities of what is
13 in this report, for us to say what is the most important. But
14 we were trying to see what we could put out quickly that
15 maybe could actually be implemented on a faster track -
16 realizing though, as Bob Herz just mentioned, that change, in
17 itself, adds to complexity, and so part of this is how the
18 change is going to be happening.

19 But I don't want this to imply that these are the
20 most important, but this is maybe sort of mulling it through
21 that helped us to find how we can lay out some principles
22 that deal with complexity.

23 MR. DIERMIER: I partly wanted to respond to Bob
24 Herz' question, just by stating that, in terms of the
25 underlying principle, I strongly agree with the principle and

1 with the preliminary recommendations that are put forward.

2 We all know that there are analysts and others who
3 have intellectual capital subclasses in certain structures,
4 and we certainly don't want to let their subclass basically
5 affect the public good.

6 MR. POZEN: Greg?

7 MR. JONAS: Just let me pile on to Bob's question
8 and Jeff's observation that we face this dilemma at the
9 rating agency every day - the dilemma being the trade-off
10 between industry-specific focus versus cross-industry
11 analysis.

12 And the family unit in the rating agencies are all
13 industry teams, so there is every risk that industry focus
14 becomes a siloed activity. But, yet, ratings are supposed to
15 be looking across industries, as well. And so we have
16 portfolios with reviews that specifically try to look at
17 those industries.

18 This is a long-winded introduction to say I
19 strongly support the recommendations because I think it would
20 really help cross-industry analysis, which a lot of users
21 seek.

22 MR. POZEN: I do think, Linda, that - just to
23 emphasize Sue's comment, I think that some of the other
24 issues that we will get to in Subcommittee I are much more
25 challenging. So I think the idea was that they may take much

1 longer.

2 But I think there was a strong consensus on the
3 subcommittee - and I hear it on the full committee - that
4 these two approaches make sense. And I think Bob Herz has
5 probably been the most articulate spokesperson for the point
6 of view that they do add a lot of complexity to the
7 situation.

8 I think the challenge is to find out how we could
9 actually do away with industry-specific guidance, and this
10 probably would take quite a long time.

11 But I think if we started to provide a principled
12 approach for FASB, then, over time, we could get to a
13 different place. And I think it would also add urgency to
14 things like revenue recognition, because that's an area where
15 the lack of general guidance has led to tremendous divergence
16 among specific industries.

17 So I think that this is quite a worthwhile
18 proposal, though I agree it's not - its difficulty is more
19 in the political sense than in the conceptual sense.

20 Denny?

21 MR. BERESFORD: Since, Sue, in your very last
22 paragraph, you refer transition issue to Subcommittee II,
23 could you please tell me what you think those are.

24 MS. BIES: Well, I think part of what we were
25 trying to consider as one of our criteria is just a cost

1 benefit issue; that whenever you change an accounting
2 standard, the preparers have to go through a tremendous
3 amount of work to get information flowing in a different way.
4 And auditors have to be geared, and users have to understand
5 it.

6 We, in our subcommittee, are not really trying to
7 look so much at the process. And so this is one of those
8 issues that we hope gets addressed in Subcommittee II, in
9 terms of thinking about change in and of itself.

10 What we were trying to look at is the accounting
11 standards that create complexity. And so what we are just
12 trying to do is to throw it to the appropriate subcommittee
13 to say, "How you answer that could affect what we want to
14 come out with on our principles, just because of the
15 challenge of change."

16 MR. BERESFORD: Would it be as simple as suggesting
17 that all such changes be prospective in nature, or is it
18 something more specific or complicated?

19 MS. BIES: I think prospective treatment probably
20 would be helpful in some cases because, again, I know, as a
21 former preparer, one of the challenges always is, if you
22 change the framework, finding the information historically
23 around which to structure the new information - you probably
24 never gathered it that way. So that is very difficult. So
25 that's one criteria.

1 I think the other is being realistic about the
2 length of time it takes to implement changes, especially if
3 you are small- and mid-sized companies, who our subcommittee
4 spends a lot of time worrying about. They don't have a huge
5 staff of accountants who can just deal with the accounting
6 reporting.

7 And so working it around all the other business
8 imperatives of an organization is an issue, and so we would
9 hope that there would be some reasonable consideration, when
10 standards are put out, to think about how long the change
11 could effectively be implemented.

12 I think, in the world of risk of financial
13 misstatements that have been in the last few years, too rapid
14 a change can create problems also. So I think that's the
15 other issue.

16 MR. POZEN: I think there might be, besides
17 prospective, which I think we would generally agree is the
18 way to go, the FASB should not be proposing things on an
19 industry basis, like, "Here's a proposal for the insurance
20 industry," so that, going forward, there should be a more
21 activity focus.

22 And, second of all, as I said, if there are areas,
23 like revenue recognition, which have tended to generate,
24 because of the vacuum, a lot of industry-specific guidance,
25 that those be higher on the priority list. And I know that

1 the agenda setting is important to Subcommittee II.

2 So I don't think there is something really dramatic
3 here. These are pretty practical procedural suggestions.

4 Yes, David?

5 MR. SIDWELL: One of the things that we have been
6 talking about is the codification project. And, actually, if
7 you think about that and look at, really, what it is today,
8 which is a compilation in one place of what the standards
9 should be.

10 I think phase two of the codification project is
11 being able to get to the standards that we want to have and
12 should differences be permitted or not in a very specific
13 way. Because I think, as you said earlier, there are
14 different causes, and I think it's hard to generalize. But
15 codification does provide an opportunity.

16 MR. MCCLAMMY: I think the other important point is
17 we have a recommendation that the FASB should analyze all
18 existing standards. And I think your committee needs to
19 decide where that ranks in the priority of the things that
20 come out of this committee, or for the FASB to focus on.

21 MR. POZEN: Well, why don't we -

22 MR. COOK: Could I just make one observation on
23 this point and then - a separate item. I'm supportive of
24 the notion of eliminating complexity, and, to the extent that
25 industry guidance and alternative accounting is a source of

1 that, I kind of feel like you shouldn't be against that.
2 That's kind of a fundamental principle.

3 But I also question and suggest that we not
4 sacrifice quality for the elimination of complexity. There
5 are some very industry-specific activities that you can
6 generalize them if you want. You can say "anybody who drills
7 for oil" and not say that that pertains only to oil
8 companies.

9 But, as a practical matter, there is a very real
10 need, I think, for some specific guidance in some of these
11 areas, whether it's insurance, or whether it's energy, or
12 what it might be. And I would hope that one of the things
13 that wouldn't happen is, by shifting from calling it an
14 industry practice to calling it an activity, we wouldn't lose
15 the guidance that needs to be there for how do you deal with
16 some of these very complex issues, and financial
17 institutions, and energy companies, and some of the others.

18 Now, I would also be the first to admit that there
19 is some pretty bad accounting that is masquerading around
20 these days under the heading of industry practice, and I'm
21 not suggesting that we perpetuate that.

22 But I would be a little cautious about this, only
23 from the standpoint of if we go away from it and we say,
24 "Wow, just a broad revenue recognition standard will solve
25 our problems here," without recognizing the uniqueness of the

1 application of that to particular types of products and
2 particular types of industries - I'm a little skeptical
3 about where that might take us.

4 So I would just say proceed with caution, I think,
5 is what -

6 MR. GRUNDFEST: I agree with all of that, but if I
7 just might share a political observation - you know, boil it
8 down. There is a lot of junk in these industry-specific
9 standards that have arisen over time for political reasons.
10 All right? You've got an industry, they want a particular
11 treatment. It makes no intellectual sense.

12 So the question, then, becomes: What is a rational
13 political strategy for flushing some of the junk out of the
14 system? Okay?

15 Now, the only way you're going to be able to do it
16 is by saying, "Look, we're taking a system-wide,
17 accounting-wide approach towards getting rid of these
18 industry-specific standards."

19 Now, ideally, what will happen is this becomes a
20 general way, not of targeting a specific industry - because
21 if you go out there and if you target oil and gas, you're
22 dead. All right? If you go out there and if you target
23 insurance, you're dead. Rather saying, "Guys, we've got a
24 principle problem. What we need to do is fix the accounting
25 system altogether."

1 Now, if we are intelligent about how we do it, we
2 will flush a lot of the bad accounting, while keeping the
3 industry-specific guidance where the industry really is
4 engaged in an activity that is unique.

5 So to the extent that you've got extractive
6 industries that need particular types of accounting -
7 whether it's oil, or gas, or coal, or what have you - great.
8 You deal with that. That's a unique activity.

9 But, as political matter, unless we call a spade a
10 spade and say there's a lot of bad accounting out there that
11 doesn't help anybody and, "Here is our strategy for getting
12 rid of it across all of these groups," we're going to be
13 stuck with it.

14 MR. POZEN: I think the subcommittee has tried to
15 recognize both Joe's point of view and Mike's point of view
16 in saying, "We want to move in that direction, but we want to
17 be cautious in really looking at it and see that we are not
18 throwing the baby out with the bath water."

19 Bob?

20 MR. HERZ: I think those are both good
21 observations. One of the ways we think about it is in terms
22 of convergence, because we have lots of industry-specific
23 standards that evolved over time, largely from the AICPA.
24 They are part of our literature now.

25 The IFRS literature did not develop that way. They

1 do have some industry standards for financial institutions,
2 broadly. They are working on insurance. They are working on
3 extractive industries. They have one for agriculture. But,
4 other than that, they have not developed - and I don't think
5 intend to develop - you know, within financial services,
6 each little pocket - not the big pocket, but
7 differentiations and all that.

8 And so if we were to go about doing this, I think
9 we would probably try to link it also into the convergence
10 effort, so that we could do both at the same time.

11 MR. POZEN: Yeah. I think that's a good point.

12 I would like to try to ask Susan to continue on and
13 look at pages 8 and 9, where we have the next proposal on
14 bright lines. I think it has particular applicability to
15 today's situation.

16 MR. QUIGLEY: Bob, I'm sorry. Jim Quigley. Can I
17 just make one comment before we leave this point?

18 MR. POZEN: Sure. Sure.

19 MR. QUIGLEY: In the underlying principle on page 5
20 of similarly activities being accounted for similarly, I
21 think that we should at least acknowledge and move with
22 caution - because I think these industry guides actually
23 help us accomplish that objective.

24 And what I mean by that is the insurance guide
25 provides guidance for accounting for insurance activities,

1 whether those activities are carried out by an insurance
2 company or whether they are carried out by an insurance
3 operation in a diversified enterprise.

4 And so I don't think we should just immediately
5 decide let's throw out all of the industry literature and we
6 will be able to accomplish this underlying principle. I
7 think the industry literature helps us accomplish that
8 principal in many ways.

9 MR. POZEN: Thank you, Jim. And I think that's an
10 appropriate caution.

11 In the interest of time, I would like to move on to
12 make sure we get a chance to cover all the other issues on
13 Subcommittee I.

14 MS. BIES: Thanks, Bob. The two big issues
15 remaining are the ones that we are really wrestling with.
16 Both of these - in terms of bright line testing and,
17 secondarily, the issue about the mixed attribute fair value
18 models - I think are going to be the bigger issues that this
19 subcommittee is going to wrestle with. And what -

20 MR. POZEN: Maybe we should take them up
21 separately.

22 MS. BIES: Yes, I'm going to take them in turn. But
23 I think what we were trying to do on both of these is to
24 really sort of get at sort of the root cause of a lot of the
25 issues that we are seeing that are happening because of the

1 changes in business. And some of these are due to recent
2 events that reminded us how important these issues are.

3 And we will take bright line first because I think
4 that is an issue that is more familiar to more folks.

5 Bright lines have been around a long time. And for
6 many of us, things like bright lines for lease accounting has
7 been around, and we have all had to wrestle with it for a
8 long time.

9 But, on the other hand, we also have bright lines
10 that have arisen in terms of some of the securitization
11 activities, so that deals are structured to get a particular
12 treatment. And one of the issues that I think has happened
13 in the last few months has reminded us that some of the
14 complexity is done to structure transactions to make sure the
15 transactions result in the right accounting that the company
16 chooses.

17 So when we teed up the bright line test, one of the
18 root causes, we think, of the complexity here is that it is a
19 bright line. It's a yes/no kind of a test. If you are over
20 the line, you do it one way. If you are not over the line,
21 you do it another way.

22 When, in fact, what you really have in these kinds
23 of transactions is a range of potential outcomes. The
24 accounting recognition today does not reflect that range of
25 potential exposures.

1 And so one of the notions under bright line that we
2 wanted to tee up for discussion is: Should we go away from
3 an on/off switch and move more toward a proportionality test,
4 where you recognize the proportion of an activity that is
5 influencing the financial results and, in the future, will
6 influence the financial results of the reporting entity?

7 And so you don't have an all-or-nothing test
8 anymore. As you move on a lease, it isn't a 90 percent test.
9 You just reflect that proportion of the economic obligation
10 that is due to the structure of your deal, and you don't have
11 an on/off switch.

12 We think that maybe would help, in the sense that
13 you're not going to have these big surprises because someone
14 hadn't bothered to look at some of the footnote disclosures.
15 Really, disclosures are also very important, but we think
16 recognition needs to be factored in here, too.

17 And so, really, under the bright line, what we were
18 trying to do is say: Should proportionality really dominate,
19 rather than on/off switches, for these bright line tests?

20 We recognize some of these have been there for
21 years as a way to sort of give preparers a safe harbor.
22 Here, if you test this way, you know you're okay. But we
23 think a proportionality test will actually help the preparers
24 in that it helps them understand the range of exposures they
25 truly have.

1 MR. POZEN: Yes, Ed?

2 MR. NUSBAUM: I'm particularly excited about this
3 recommendation because I think it's something unique and
4 different. Whenever there are bright lines, for better or
5 worse, transactions are going to be structured to work around
6 or deal with those bright lines. And this concept of a pro
7 rata proportionate accounting, I think, is something that we
8 should pursue.

9 I am a little concerned that it might add to
10 complexity, as opposed to simplify things. But, on the other
11 hand, it could solve a lot of problems.

12 I think the next step should be to somehow assess
13 the practicality of it and whether or not it does a better
14 job of reflecting the economic substance of a transaction,
15 which I think is what you're talking about and is a very
16 worthwhile objective that we should be seeking.

17 I think a lot of the problems associated with it
18 might be solved through disclosure and through the principle
19 framework that our subcommittee is working on. But whenever
20 you adhere to principle-based standards, there is going to be
21 some diversity of practice. And that's okay. And this pro
22 rata solution may address that.

23 MR. POZEN: Peter?

24 MR. WALLISON: I come to the complexity issue with
25 something like the perspective of a lawyer who has practiced

1 in the securities area for quite a while. And that is I
2 think complexity is induced very often by legal liability and
3 the problems of legal liability.

4 And when you get into something like, say,
5 proportionality, it raises questions of judgment, and legal
6 liabilities come from making misjudgments.

7 The advantage of bright line is that it allows
8 people to avoid legal liability by staying within the
9 standards prescribed. Once you open it up, so that
10 principles or proportionality become the test, then when
11 accountants and preparers get into the issue of making
12 judgments, they expose themselves to legal liability. And
13 that is one of the reasons why I think we have so much
14 complexity in financial disclosure and other kinds of
15 disclosure.

16 So I think we have to be a little bit cautious
17 about trying to eliminate the bright lines. I understand all
18 the problems with bright lines. But, on the other hand, it's
19 going to make it exceedingly difficult for people, in the
20 litigious environment that we have today in this country, to
21 function without some sort of very specific guidance.

22 MR. GRUNDFEST: Well, Peter is absolutely right, of
23 course, to blame everything on the lawyers. I'm surprised it
24 took this long for us to get to that fundamental truth.

25 MR. POZEN: And you're churning them out every day,

1 Joe.

2 MR. GRUNDFEST: At a furious pace. And all of you
3 keep wanting to hire them at ever higher and higher rates, so
4 the market is sending quite a signal here.

5 At the same time that we move away from the bright
6 lines, I think we do have to create safe harbors. All right?
7 So, you know, Peter is exactly right.

8 We are - if what we do - let's take maybe one of
9 the simplest examples, and that's lease accounting. Okay?
10 There's a certain bright line to keep leases off your books
11 if they meet certain standards. Well, you know, you say,
12 well, wait a minute. You've got 80 percent of the value or
13 90 percent of the value. Well, then, recognize 80 percent or
14 90 percent this way or that way. All right?

15 That's really fairly straight-forward. The math
16 behind it is pretty clear. And I think articulating what a
17 safe harbor might be for that is probably not very
18 complicated.

19 On the other hand, we have to understand that there
20 are other situations which are just, you know, hair-raisingly
21 complex. Let's look at the current situation with regard to
22 SIVs. All right? The problem that you're running into is
23 one that, if you would have described it a year ago, people,
24 in good faith, would have said, "This is a low probability,
25 high magnitude event." We wouldn't really know what

1 percentage of this potential exposure, which now resides
2 totally off the balance sheet, to pull through and recognize
3 anywhere in the financial statements.

4 Personally, I'd be of the view that, in that
5 situation, you don't go to any pro rata measure, or what have
6 you, but there is another disclosure approach that could be
7 taken because, at some level, the issues associated with
8 valuation and the like become such that they really aren't
9 susceptible of any clear method of quantification; rather,
10 they are better addressed through description, without
11 quantification.

12 And I think this is going to be one of the problems
13 we run into as we go down this path. There will be certain
14 types of situations where, okay, it makes sense, without
15 generating a lot of additional legal liability, to
16 proportionally allocate. In other situations, don't even try
17 to do it. Just describe what the issue is.

18 But I agree entirely that figuring out how to
19 reduce the legal liability associated with this stuff is
20 essential because so much of the problem we run into is the
21 accounting equivalent of defensive medicine. All right? It's
22 CYA because none of us can afford to be sued over this event
23 in the event a problem arises.

24 MR. POZEN: Ed, and then Mike.

25 MR. MCCLAMMY: I think the other thing that Joe

1 actually brought up to our subcommittee was that, if you look
2 at a lot of the litigation, it's people trying to prove that
3 someone, rather than being one percent on the right side of
4 the bright line, was really at one percent on the down side
5 of the bright line. And under what we are proposing, that
6 would make a two percent difference. Under the current
7 accounting, it makes a 100 percent difference because of the
8 on/off switch.

9 So I think he convinced us that, in some cases, it
10 actually may make the situation better.

11 MR. POZEN: Mike?

12 MR. COOK: Bob, I support this recommendation. I
13 think it has potential to really do something very good. I
14 would prefer - I think a lot of people would prefer, you
15 know, the broad principles, which would say, if we were
16 talking about leasing, if you own and operate an asset, put
17 it on your books. But by the time we finish defining what
18 owning and operating means, we are back to where we were.

19 I think this has an interesting appeal. I think
20 this proportionality will eliminate proportional - lots of
21 things, because if it doesn't matter whether you have 89
22 percent or 93 percent, you've still got to put it on your
23 books. The 11 percent other owners are going to, over time,
24 disappear, or they are going to be proven to truly be
25 substantive, and then there is going to be a difference.

1 But all of these things that are being created for
2 the purpose of, "Get me under X," or, "Get me above Y" - and
3 I'm reminded - I'm not up-to-date on this, but I'm reminded,
4 at one point in time, a little study was done that determined
5 that about two-thirds of all the airplanes that were flying
6 in the skies of the United States were not on the financial
7 statements of anybody because they weren't on the financial
8 statements of the people whose names were on the side of the
9 planes, and they weren't on the financial statements of the
10 people who financed those planes.

11 And something that would improve that situation in
12 steps would be a practical step forward, in my mind. I don't
13 know if that's still the condition today, but I wouldn't be
14 surprised.

15 MR. POZEN: Yes, Bob?

16 MR. HERZ: I think it's a good idea, and I would
17 ask the group, just from our point of view, as we go forward
18 -- the way we have been thinking about this is account for
19 rights and obligations that you have, rather than who has
20 enough of the ownership to put it on their books. Then you
21 have bright line tests, and all that. And then you get the
22 either/or thing.

23 Whereas, if you look at a lease, you say, "Gee,
24 I've got the use of this equipment for 10 years. I've got to
25 make 120 payments. Let's put those on the books because

1 that's what the contract says."

2 So we are thinking about proportionality as more of
3 kind of a rights and obligations way of thinking. And this
4 is very timely because that's exactly where we are in our
5 looking at the conceptual framework. So I would ask you to
6 think about whether your idea of proportionality matches the
7 way we are thinking about it or not.

8 MR. POZEN: I think we will be getting some input
9 from the FASB on where you are on that.

10 And I did also want to emphasize Joe's point that
11 there are situations, like with the SIV, where there is a
12 back-up liability, which is, really, more a probability
13 issue. And so this may not be amenable to proportionality.

14 But what I think Joe and the subcommittee is
15 thinking of is some way to alert the investing community that
16 there is a contingent liability here. We're not sure exactly
17 what the probabilities are, but, at least, to start to
18 delineate that there is something there, so, in that two or
19 three percent of the cases, when it comes to fruition that
20 it's not a surprise.

21 And this is a possible approach and would,
22 hopefully, not involve quite as much legal liability as
23 proportionality.

24 So I think that area - I sense a lot of support
25 for it, though I think we would all agree that the practical

1 working out of it would be quite a challenge, and that is
2 what we are going to try to do.

3 I think, Sue, if we could just try to get to page
4 10 and look at this very challenging issue that the
5 subcommittee has laid out here.

6 MS. BIES: Well, this, I think, is the toughest
7 issue that we have, at this stage, laid out - because this
8 sort of goes to the heart of the accounting framework and
9 presentation.

10 Let me sort of tee up a couple things that we
11 struggled with that are detailed in these pages, starting
12 with page 11 and continuing.

13 What we think - again, think of the different
14 constituencies here that we have. One of challenges, when we
15 have the mixed attribute model and the growing use of fair
16 value accounting is to say, "Why are we doing this? What is
17 the relevance of this for these kinds of activities?" And,
18 again, I want to stress activities, not assets and
19 liabilities. We are focusing on activities.

20 I think about it, you know, when I was a bank
21 regulator in terms of fair value may, at a moment in time,
22 represent an asset value on the balance sheet, but it is
23 nothing that, as a regulator, I could use to make any
24 insightful decisions about risk exposures or future
25 performance of a company because it doesn't give me enough

1 information.

2 So that carries me over into issues about how do
3 you use recognition versus how do you use disclosures.
4 Clearly, disclosures, I think, with some of the complexity,
5 could potentially provide a broader framework to describe
6 future events. Historic cost accounting and moment-in-time
7 fair value really measures where we are now and
8 backward-looking.

9 And so it isn't clear. The users of financial
10 statements, who clearly want to understand the ongoing
11 success of a company and where they are stumbling, struggle
12 when all of it is mixed up.

13 The other issues that they were struggling with, as
14 you can see in here, is: If we move more toward fair value,
15 how do we distinguish between what is realized and what
16 hasn't been realized?

17 And we have all known for years that there is not a
18 very good fit between the cash flow statements and the income
19 statement. And we think that some work around the geography,
20 I call it, of the income statement could be very helpful here
21 because you can do things like - say, you fair-value a loan
22 portfolio and it ends up being fair-valued above par value of
23 the loans, when we know no borrower will ever pay a bank more
24 than they borrowed. You know that that's just a timing
25 difference. And if that could be distinguished somehow, that

1 could help provide clarity, if we go the full fair value
2 route.

3 The other part is the way we just look at the
4 income statement per se. And our subcommittee has been using
5 the technical term "chunking."

6 What we are talking about is that: Are we really
7 grouping things together that are easily understood by users
8 of financial statements? Should we group revenue and
9 expenses more by activities perhaps than by personnel
10 expense, and equipment expense, and the different ways we
11 break things down? Would it be helpful to chunk them
12 together, so you could see what is the total revenue and the
13 total expense connected with an activity? Would that be more
14 helpful?

15 Segment reporting, we know, has gotten to be - we
16 have had several projects over the years to think about it.
17 And we do disclose it. And the way it's teed up now, every
18 time a company reorganizes and the segments get redefined, we
19 end up with the complexity problem of how do you look back
20 and restate going forward for the new business organization,
21 because companies are living entities.

22 So that is part of the issues that we are teeing
23 up.

24 But what we are trying to get to is also some
25 issues about: Should we tier the quality of the audit work

1 that is done? In other words, have companies spent more time
2 on what is material to that corporate entity and be more
3 general in aggregating information which is maybe less
4 material to the organization. So this tiered audit opinion
5 is something that we have thrown on the table to think a
6 little bit more about.

7 And then also these multiple performance measures,
8 because we know what goes in earnings releases is very
9 different, in many ways, than what goes into the official
10 financial statements. And there must be a business reason
11 for that and the users must like it. How do we look at that?

12 So this is a very broad-scoped issue, and that is
13 why we have teed up all of these points that we have
14 identified at this stage. And we would like any feedback and
15 guidance about just the general directions that we are trying
16 to go on this big issue that we are wrestling with.

17 MR. POZEN: That's a very good summary, and I
18 should just note that some of the points you made would
19 coordinate with other subcommittees. Obviously, earnings
20 releases and non-GAAP measures is something Jeff's group is
21 working on. And, to the extent there would be a different
22 audit type of opinion, that would be something that
23 Subcommittee III people might look at.

24 But I think this idea of chunking the different
25 chunks of the income statement is a very interesting and

1 challenging idea, and I would like to get people's reaction
2 to it.

3 MS. GRIGGS: I think the chunking idea is a great
4 idea. So I think that it would be helpful to the users of
5 financial statements to understand the different ways in
6 which values are being presented and the different quality to
7 those values.

8 And I think your summary of what you are looking at
9 is very helpful, and I would just encourage you to look at
10 fair value and whether there is a different - maybe not even
11 in an income statement, where certain changes in fair value
12 won't even go through the income statement. I know some
13 don't now, but whether that should be broadened.

14 MR. GRUNDFEST: Or make it much easier for
15 investors to decide whether a certain number should, in their
16 view, go through the income statement or not. I mean, there
17 is an artificial orthodoxy in the process that I think hurts
18 everybody.

19 MR. POZEN: I mean, you could think of something as
20 radical as having, essentially, two earnings per share -
21 one, which would sort of be like a core earnings per share,
22 where it would sort of be like what a financial analyst would
23 view as the sort of free cash flow number, and then you would
24 have all these others things, such as currency translations,
25 fair value changes - these sorts of things.

1 So I think part of the thinking was that a lot of
2 preparers have been very resistant to fair value because of
3 volatility, but if this was separated out from the cash flow
4 that maybe that would make it more palatable to preparers,
5 and so they could show that their core business didn't have
6 this volatility and would really start to have a much better
7 understanding of whether volatility is produced by events
8 beyond your control, or technical changes, like the currency
9 translations or the -

10 MR. GRUNDFEST: Bob, I think you are absolutely
11 right. In fact, the idea of two earnings per share numbers,
12 I think, doesn't go far enough. I think there are -

13 MR. POZEN: Oh, you always one-up me, Joe.

14 MR. GRUNDFEST: No, no, no, no, no. What I'm just
15 saying is you're being modest. Push farther. That there are
16 many situations where it is entirely legitimate and
17 beneficial for investors and preparers to report three, four,
18 or even five different earnings per share numbers. All
19 right? And that, believe it or not, I think will reduce
20 complexity in a variety of different ways.

21 At first blush, you say, you know, "My goodness,
22 you know, Citigroup reports four different earnings per share
23 numbers. Two of them are up and two of them are down." The
24 answer is hell, yes. All right? Because if you report one
25 number, it averages all of that stuff in a way that makes it

1 complicated to determine what is really going on.

2 MR. POZEN: Mike?

3 MR. COOK: Two responses. One, I'm less than
4 convinced - what Joe just said always sounds good, but I'm
5 less than convinced that this is going to reduce complexity
6 and that this is going to take us to a more understandable -
7 maybe, in some respects, more relevant, but I'm not sure more
8 understandable, and certainly not a more transparent form of
9 financial reporting.

10 But it certainly merits further discussion and
11 experimentation, so I'm not negative about it in the sense of
12 it's just a bad idea. It's just a question of, with our
13 mandate - things that are doable, things that are
14 actionable, things that are practical - this one may not get
15 within that set of principles.

16 I would also like to say, on behalf of Subcommittee
17 III, in respect to our colleagues on Subcommittee I, in
18 deference to their having lobbed this one over to us about
19 the tiered audit opinion, I assure you that we will give that
20 due consideration, and we will listen to the people we talk
21 to about the audit process. We will do some probing on that
22 subject.

23 I wouldn't think it likely, for the same reason
24 that I'm a little skeptical about the broader recommendation
25 -- I don't think it's likely, if we stick to our parameters

1 saying actionable, doable, reasonable period of time, that we
2 will be forthcoming with a recommendation on this subject.

3 So I think we will certainly look at it, as they
4 have asked us to do, but I'm not in the mood of raising
5 expectations that we are going to come forward with
6 something.

7 Until a lot of the parameters of what this would be
8 all about have been defined, it's very difficult - it's easy
9 to conceptualize a multi-tiered opinion. But I think this
10 may be a subject - we can hand off, just as they did - this
11 may be a subject for Kristen and the folks at the Treasury
12 group, who are going to study the accounting profession and
13 the auditing profession and its future viability. I think
14 that might be a topic more relevant for them than it is for
15 us.

16 So we'll look at it, but I don't -

17 MR. POZEN: I think it's perfectly reasonable to
18 wait until this is fleshed out a lot more before your
19 subcommittee takes it on.

20 But I do think - just in terms of do-abililty, I
21 think some of the thinking here is to sort of actually get
22 parallel to what a lot of the earnings releases now do for
23 companies, which is to strip out these other things.

24 So I don't think it's quite as theoretical. I
25 mean, the earnings releases by companies are going out a week

1 to 10 days before the 10-Qs, and markets are moving on the
2 basis of it. And they are choosing to sort of, in many ways,
3 bifurcate the number and to really strip out certain things.

4 So I think that there is some evidence that this is
5 happening already. So if we can understand - and I think
6 this would be a segue to Jeff - if we can understand what is
7 happening in those areas of why people are segmenting and
8 chunking numbers, I think that would be helpful.

9 MR. COOK: My view would be that that is true, but
10 I think a lot of what is happening there is because of the
11 deficiencies in GAAP, not the attractiveness of fair value.

12 MR. POZEN: Okay. Jeff?

13 MR. DIERMIER: I just want to support the comments
14 that were made - even Joe's, although maybe it's not doable.

15 The market is, without any question, trying to
16 chunk out the various segments of - as I have traveled in
17 many places in this role on this committee, as you might
18 imagine, a lot of our users, they really want to know, you
19 know, how much is coming from the operations, what is coming
20 from financing, what is coming from fair value markets -
21 they are all trying to make those estimations themselves.

22 MR. POZEN: So tell them.

23 MR. DIERMIER: And if we tell them we're in much
24 better shape - I also - just a couple of comments with the
25 paper. Sometimes, when I read things like, "Some preparers'

1 knowledge of valuation methodology is limited," blah, blah,
2 blah, I always worry if - you know, should they actually be
3 using some of these exotic instruments, if they really don't
4 have the sufficient knowledge by which to be able to describe
5 and account for them.

6 And I made a comment at the first session of this
7 group, and that is I think we are all agreement you do not
8 want to smooth anything that, in nature, is not smooth,
9 because that leads to - you know, that leads to big risks.

10 And I know you know there is a whole lot of
11 discussion out there. And companies, for too long, have been
12 told to try to manage earnings and make them smooth, but
13 that's not the right answer. You know, the marketplace will
14 be much better served if kind of the natural volatility comes
15 out. The market can recognize that. And, actually, that
16 will avoid big blowups because, you know, the little hiccups,
17 basically, are healthy things, and I think they prevent the
18 fat tail events.

19 MR. POZEN: I have Linda and then Scott and then
20 Peter.

21 MS. GRIGGS: Just a question. I notice the
22 subcommittee is considering disclosures and integrating
23 disclosures into the framework. Are you focusing on the
24 notes to the financial statements and the MD&A, or what is
25 the scope there?

1 MS. BIES: I don't think we have gotten that
2 specific yet. If you've got any particular thoughts on which
3 direction, we would love to get it.

4 MS. GRIGGS: Well, there is a tremendous amount of
5 redundancy now between the MD&A and the notes to the
6 financial statements. And, you know, maybe that's necessary.
7 I'm not reaching a judgment on whether it is or isn't. But I
8 do think it would be worth looking at that.

9 MR. POZEN: All right. Scott?

10 MR. EVANS: I'll just quickly add my voice to the
11 chorus supporting the direction of the chunking effect. I'd
12 like to also express some caution about taking it too far.

13 I think the primary thing that users and investors
14 want to do is to be able to distinguish the ongoing operating
15 cash flows from other aspects. If you take it too far, if
16 you introduce too much complexity, it will lose the value of
17 making that distinction.

18 But if we do make progress, it will standardize the
19 type of informal reports that are coming out of companies to
20 investors and guarantee that there is greater comparability.

21 MR. POZEN: Peter?

22 MR. WALLISON: I would like to second, really, what
23 Joe said before, because, again, from the standpoint of legal
24 liability, I think it's extremely important to reduce the
25 focus on a single bottom line EPS number. And this would

1 certainly be one way to do it, if there were a number of
2 different EPS numbers shown as a result of various changes in
3 the way major elements in the income statement are treated.

4 And what you can show, then, is that, if we treat a
5 pension obligation this way, this is our bottom line number.
6 If we treat some other major element another way, this would
7 be the bottom line.

8 And that actually reduces the potential liability
9 of the company because, if it turns out ultimately - and not
10 only the company, of course, but the preparer, too, and the
11 accountants. If it turns out that a mistake was made in
12 judgment, again, about how to treat something, at least, you
13 have exposed what a different treatment would produce.

14 And so I think there is a lot of good sense in what
15 Joe was suggesting here, and I think it ought to be seriously
16 considered by the subcommittee. Thank you.

17 MR. POZEN: I have Charles, and then Greg, and then
18 Bob. And I think then we're going to have to cut it off for
19 Subcommittee I.

20 MR. HOLM: I would like to comment on the issue of
21 fair value. I think the committee is taking, you know, a
22 cautious approach towards movements to fair value accounting,
23 which I think, overall, is consistent with the bank
24 regulators' view.

25 We see conceptual promise with fair value, but,

1 again, we have always cautioned a lot of concerns about the
2 reliability of the estimates when you get away from the
3 liquid and into the more illiquid products - the ability,
4 you know, to audit and verify that information.

5 And also it's the whole infrastructure there, for
6 the valuation expertise, but also the disclosures around fair
7 value. For example, in today's more historical cost world,
8 you know, with all its imperfections, if you look at, for
9 example, the loan loss allowance, with it, we get a lot of
10 comparisons we can do to problem loans, net charge-offs, and
11 various type of metrics and measures that we can
12 fundamentally analyze the information.

13 But as we move to fair value, we need similar type
14 of metrics and disclosures to fully understand those numbers,
15 especially when it's a liquid product.

16 So I'm glad that - I think the FASB and the SEC,
17 overall, have been taking a long-term view on this approach,
18 and I think the subcommittee is right - it's a good issue,
19 but it needs careful thought before we can get to the
20 conceptual promise of fair values.

21 MR. POZEN: Thank you. Greg?

22 MR. JONAS: As the subcommittee appropriately
23 noted, the FASB and the IASB have a joint project for
24 financial statement presentation. And I really would
25 encourage the subcommittee to study that project closely.

1 It offers, I think, the single biggest chance for
2 improvement, from a user's perspective, for standard
3 reporting in many years. And it does so because standard
4 setters have really never given much attention to chunking.
5 And this project is doing that. The tentative thinking by
6 the two boards, I think, is absolutely outstanding, and it
7 really goes a long way toward achieving many of the
8 objectives that commenters today and the paper has alluded
9 to.

10 One other point. And that is I thought the
11 discussion on pages 12 and 13 was very substantive. There
12 was one notion, though, I just wanted to mention for caution.
13 And that is the concept of a moratorium. A moratorium is
14 appropriate if there is a light at the end of tunnel when the
15 moratorium comes off. And this moratorium would be a
16 function of the progress on the decision framework on the use
17 of fair values.

18 That decision framework is badly needed, but it is
19 the most controversial thing going in the world of accounting
20 and reporting, in my view. And history tells me that that
21 project could go for a very long time, and a moratorium could
22 turn into a funeral. I think we need to make some progress
23 on fair values in the meantime. So just - I'm a little
24 nervous about moratoriums in this case. Thank you.

25 MR. POZEN: Thank you. Bob?

1 MR. HERZ: I had two comments. One was the one
2 that Greg made about our financial statement presentation
3 project because that is - we have developed a number of
4 chunking principles.

5 MR. POZEN: I guess "chunking" is becoming a real
6 term of art.

7 MR. HERZ: Yeah. That's not the words we use, but
8 this grouping principle, whether it be operating versus
9 financing versus investing, whether it be fair value and
10 other types of remeasurements - because there are all sorts
11 of other remeasurements that go on in historical cost
12 accounting that have nothing to do with the ongoing business.
13 And those are hidden right now, so that other type of
14 information - the quality of the measurements versus, you
15 know, harder versus softer, and all those.

16 So, again, it's just my selfish plea. If you look
17 at this, you can look at our chunking principles and comment
18 on which ways you think those are most useful.

19 MR. POZEN: Well, I think this clearly is going to
20 be a very controversial and challenging subject.

21 John, did you want to say something?

22 MR. WHITE: Yes. I guess I like the idea of
23 addressing chunking in the financial statements, if that's
what
24 you are suggesting here, because, at the moment, we end up,
25 basically, in Corp. Fin. Addressing, or looking at it, and it

1 appears in the MD&A, or more likely in the press releases
2 where all the input is, applying, really, the non-GAAP rules.
3 And we have very few standards for that. It's a pretty hard
4 task for us, in terms of the way we interact. And if you
5 would address chunking in the financial statements, I think
6 that would be very helpful.

7 MR. POZEN: Thank you. I think we are going to go
8 on to Subcommittee II. Are people prepared to go on, or do
9 they want to take a break? Are there people who want to take
10 a break, or do you think we can get through II and then take
11 a break after II? It sounds like we can get through II.
12 Okay.

13 David, why don't you kick this off on the standard
14 setting process, Subcommittee II.

15 MR. SIDWELL: Thank you. Let me just say thank you
16 to the participants in this, particularly Mark and Bob, who
17 have attended most of the meetings that we have had. Jim
18 Quigley is on the phone, by the way, if anyone wants to
19 direct a question at him.

20 In terms of scope, the first area I propose to
21 raise with you, I think probably the most important aspect of
22 this is what we chose not to do at this point in time, which
23 is to focus on the international arena. And I don't think we
24 are doing that from being naive that the world isn't
25 changing, but more from the practical view that there is a

1 huge amount going on, in terms of the invitation for comments
2 that the SEC has had both with foreign providers and also
3 with potential domestic companies involved under IFRS.

4 Obviously, in the landscape that we are talking
5 about, the processes can change very significantly. We
6 didn't want to deal with some of the what-if around that. We
7 recognize it. We will come back to it, as necessary.

8 However, having said that, the way that we have
9 approached the questions of the process is to say you need to
10 look at this holistically and think about the process in
11 terms of what is your governance structure, what is your
12 process around setting the agenda, what is your process for
13 actually disseminating standards, and how do you think about
14 the communication of standards.

15 So to really think about, if you like, the entire
16 process in a way that I think, when we get to the question
17 that we are dealing with, the international environment and
18 any changes that we make here in the U.S. based on some of
19 the decisions that are yet to be made - I think we would
20 think that you would want to slot it in the same conceptual
21 framework of what is a good standard setting process.

22 So we have from the scope perspective of the
23 committee focused mainly around governance, around how the
24 agenda is set, how the standard setting process is, how
25 interpretations are offset, and then to frame a little bit

1 this hard question of when you think about what is our ideal
2 standard and what are some of the principles that we should
3 be using.

4 So I guess that's the first question for the full
5 committee: Does the scope of it sound appropriate?

6 I know there are lots the hypotheses laid out in
7 our paper. We did that pretty much to be clear about what we
8 meant. I think we all felt that we could give very
9 high-level general statements, which I think everyone would
10 interpret differently. We thought it was important to be
11 reasonably specific within the categories that we identified,
12 so that you could really understand what we were driving
13 towards.

14 MR. POZEN: Do we have comments on the scope here?
15 I think most of the points on scope are pretty consensus
16 issues. I do think this question, as David has enunciated,
17 about the international is an area where our committee is
18 struggling. On the one hand, we all recognize that IFRS is
19 alive and well, and IASB is there, but I guess my personal
20 view is that we need to sort of proceed on the structure that
21 is in place.

22 It may be the case that, 5 or 10 years down the
23 road, this structure will change. And we ought to, as David
24 says, keep that in mind and try to design processes that
25 would be appropriate. But I'm a little concerned about our

1 trying to shoot at two moving targets at the same time. That
2 would be a little difficult.

3 Bob?

4 MR. HERZ: I think I partially agree with you -
5 not completely. I think that it really -

6 MR. POZEN: I had a sense I wouldn't get your full
7 agreement.

8 MR. HERZ: There are issues of overall governance
9 of standard setting, approach to standards - things like
10 that - that would apply to us, apply to the IASB, apply to
11 the Martian standard setter, whether we are in a convergence
12 mode or not.

13 But there are things relating to agenda, staffing,
14 things like that, that one has versus the other. In other
15 words, if we were to continue on convergence, or even, you
16 know, decide to accelerate it because of SEC decisions or
17 comments that are made there on their release, some of those
18 things, the path chosen would make a big difference over the
19 next three, five years, at that level.

20 So I'm agreeing with the broad things around the
21 governance - the ingredients of a good standard, good
22 process for standard setting, and all of that - but the more
23 detailed things about our agenda, our standard setting, those
24 would - one path versus the other would make a very big
25 difference.

1 MR. POZEN: Well, I think, for better or worse, I
2 mean, we are assuming, on the one hand, that there is a
3 movement toward convergence. But, on the other hand, I guess
4 those of us - and I'll say personally - are a little more
5 cynical about how fast that is going to come; that we are not
6 planning on it happening in 3 years and, you know, sort of
7 view it as a more long-term goal - "long-term" being maybe 5
8 to 10 years.

9 So I think, Bob, we just need to have some working
10 assumption here, so we will be thinking in terms of, you
11 know, moving toward convergence. I just don't think it's
12 really realistic for us to assume these boards are going to
13 merge in two or three years.

14 MR. HERZ: That may be the case, but let me give
15 you a real - at least, from my perspective, the real life
16 dilemma. The real life dilemma is that, not only we, but our
17 whole system, is riding two horses right now. We're riding
18 to improve and maintain U.S. GAAP. We are also riding to
19 improve and converge an international approach.

20 Now, if you look at our agenda, it has 41 projects
21 on it, and a lot of that occurs because, when you draw those
22 circles, they're not exactly - those that have been
23 diagrammed, it's not exactly overlapping.

24 Now, that may be the way the system wants to
25 continue to proceed, and that's the debate that I think needs

1 to be had, after the SEC gets all of their responses and
2 analyzes, and all that.

3 But I'm just saying that I think some of the - not
4 the fundamental things around the governance of standard
5 setting, around the ingredients of the process, around the
6 ingredients of good standards - those are immutable, should
7 be immutable, almost immutable - but the issues of agenda,
8 staffing, and things like that, are invariably going to be
9 related to whatever the path that is chosen.

10 MR. POZEN: Ed? Ed and then Ed.

11 MR. MCCLAMMY: I do think it's important, either
12 whether we address it or someone else addresses it. But we
13 have to address it, if we continue to converge. Or do we set
14 a date in which we say, "We adopt"?

15 Because this - you know, whether it's from your
16 process where you're talking about balancing all these
17 projects and from the users, and particularly representing
18 mid-size preparers, it's a death from many changes.

19 And, you know, in some ways, I think we would be
20 better off to bite the bullet and just say, at some date,
21 even if it's 5 or 10 years from now, you know, everyone will
22 be on one set of standards and don't try to gradually get
23 there. Everyone just should be there.

24 MR. SIDWELL: Can I just say one thing?

25 MR. POZEN: Sure.

1 MR. SIDWELL: Obviously, I think this a debate that
2 could go on a while. What we're saying is we need to be
3 fluid. I think that many of the things we are considering
4 would be applicable as an offset in any system. I think that
5 is helping us frame a view on those things, and I think we
6 would be very willing to come back to this post January and
7 really give more thought to it.

8 I think, by definition, it probably needs many
9 recommendations, per se, at a reasonably high level, because
10 I think we could be wasting a lot of bandwidth getting very
11 specific on some of the details, when the system is going to
12 change. But I still think we can frame some very meaningful
13 recommendations that would help us think about how
14 international standards would work. And that's what we
15 wanted to do.

16 MR. POZEN: And I think we will have the benefits
17 after January of the comments on the conceptual things.

18 Ed?

19 MR. NUSBAUM: I agree with David's last comment to
20 stay at a high level. The convergence, while we may not
21 immediately, or even in the next few years, adopt all the
22 IFRS standards, as we develop new standards, we are trying to
23 do it on a joint basis.

24 MR. POZEN: Right.

25 MR. NUSBAUM: So if we are trying to move towards

1 pro rata accounting - for example, for leasing - we can't
2 ignore the IFRS because we want to - certainly, for most of
3 us, we believe, it would be preferable to have a global
4 standard that we all buy into. And so we want to reduce
5 complexity on a global basis, and I think this committee
6 should look at how we do that.

7 MR. POZEN: Mark?

8 MR. OLSON: Just to supplement some of the
9 discussion here, when you talk about governance issues, I
10 think it implies a couple of things. It implies a need, on
11 the one hand, but also it implies that you are looking at the
12 structure of your decision-making process.

13 From the PCAOB's perspective, being in an industry,
14 if the industry is audit oversight - a mandated audit
15 oversight, it is an industry group that has sprung up within
16 the last five years, for the most part.

17 And what we discovered was that there was almost an
18 immediate need for some kind of an international cooperation,
19 not because of the fact that we were looking for things to do
20 with our time, but because we recognized the fact that it's a
21 global economy and that, as a result of it being a global
22 economy, we needed to work together. So the group has
23 started and is functioning pretty well for a nascent group.

24 The point is that I think we ought to recognize
25 that convergence, or adoption, or whatever way we want to go

1 is a function of the global economy and that there will be a
2 -- I think there will be a continual move toward single
3 standards. And so I think that it is the result of the
4 environment we are in, and we are not creating the
5 environment.

6 And I think that, where accounting goes, audit will
7 probably follow it, to some extent, either just because we
8 are working together, or the fact that there will be an
9 effort - a specific effort to try to bring it about.

10 MR. POZEN: Okay. I think we probably have pressed
11 that as far as we can. David, do you want to continue on?

12 MR. SIDWELL: Yes. We provided an overview section
13 because I think some of the hypotheses that we are developing
14 really do fit together, and I really would encourage people
15 to look at the overview.

16 The one thing I would like to emphasize here is
17 that - and I think Sue and her team went through it very
18 well - some of the causes of complexity. And many of them
19 have in their roots in our fear that good faith judgments are
20 going to be second-guessed; that that significantly
21 influences the behavior of many participants in the system.

22 So I think for our recommendations to have any
23 chance of really significantly changing the way the system
24 works it is going to require a change in behavior along the
25 way. And I think that is extremely fundamental; that if we

1 don't move away from a system where people feel they are
2 second-guessed with a proliferation of interpretations, the
3 desire for bright lines, as such, will continue.

4 So some of what we have tried to do as we have
5 framed our recommendations is to, hopefully, expect some
6 degree of willingness to change behavior.

7 We have tried, again, to set out in this overview,
8 to base our recommendations on, really, a very proactive
9 feedback loop, so users are much more involved and many of
10 our recommendations are framed around an understanding that
11 users will be represented at all level of the process,
12 whether it's the FASB, actively involving the advisory
13 committees, but then also when we think about the way
14 standards are set and the degree of interpretation that
15 follow this occurrence, that we are engaging in having much
16 more involvement of the SEC, the FASB, and principal
17 participants in the system, actively saying, "What are the
18 key agenda items? Who is going to give the authoritative
19 literature? How do we think about practices that are
20 developing, and whether some of the what I call informal
21 guidance that is being given should be considered as we think
22 about the standards?"

23 So to think a much more proactive environment,
24 where, again, it's not just that a standard is issued by the
25 FASB, and you don't think about and come back to it 10 years

1 later, but that there is a much more active dialogue between
2 all participants in the process to make sure there is a
3 continual refresh, where it is appropriate to make that
4 refresh, and to try and help draw the line better about what
5 is significant enough to require formal guidance and what
6 isn't, and the diversity in practice that results is
7 acceptable. And that was - as you go through our
8 hypotheses, that's a fairly significant part of it.

9 Having said that, maybe let me just begin with the
10 -- which is on bottom of page 4 - governance. We felt that,
11 if one of the objectives of the work we are all doing is to
12 address the needs of users, then it goes without saying that
13 we should be encouraging more user participation throughout
14 the entire process.

15 And some of the active steps we thought that could
16 be taken here is that, when we think about the FAF, when we
17 think about the FASB itself, and when we also think about the
18 number of advisory committees that the FASB has been trying
19 to engage, there is, I think, in our view, considerable
20 benefits to be had by having more user representation.

21 And I don't think that that is just necessarily -
22 and I might ask any of my committee members to join in this
23 -- saying that it would force us to write things more simply,
24 because these are not technical accountants writing laws, but
25 that we would really benefit from having much more active

1 engagement of users. And that would go through the whole
2 process, including more active field-testing, so that we
3 really do get the benefits, as we go along.

4 So that's, really, the first premise that we have,
5 which is around the governance - involving more users. We
6 think, overall, that the process, in terms of delegated
7 responsibility for the SEC to the private standard setting, I
8 think, in general terms, we don't see that as something that
9 we should spend lot of time on.

10 By definition, a lot of the other recommendations
11 we have we hope will tighten up the process that makes that
12 more effective. But that was, really, the first body of
13 recommendations.

14 MR. POZEN: And I think, as you point out here, FAF
15 is also in the process of reconsidering and would be coming
16 to your subcommittee to give us a report.

17 Anyone have reactions to that? Greg?

18 MR. JONAS: I just - violent agreement. Here is
19 an area where I think our own FASB is well ahead of many
20 other standard setters. FASB has done, I think, some
21 terrific things in the last five years to bring users into
22 the process. It has historically been a very difficult route
23 to get standards into the process, and Bob and his team have
24 found ways to do that that I think have been extremely
25 useful. And I would encourage the subcommittee to study

1 those a little bit because I think it is excellent.

2 MR. POZEN: I think we ought to go on to the next
3 -- I think that's sort of a -

4 MS. GRIGGS: I just know that BDO recommended in
5 their comment letter that there be both full-time and
6 part-time user members of the FASB and that users be, you
7 know, maybe part of the FASB. I don't know if that's
8 workable, but it's certainly worth giving consideration.

9 MR. POZEN: I think that is an interesting
10 suggestion because we have talked about the difficulty of
11 getting really top-notch users to be full-time. It's
12 difficult to give up, you know, that sort of private sector.
13 And so that's surely something that ought to be on the table.

14 But let's move on to agenda and standard setting -
15 a pretty meaty area.

16 MR. SIDWELL: Yes. This area is really focusing on
17 a number of areas. I'd like to start with the area of how
18 the agenda is set with some of our preliminary presumptions
19 around what the authorities of the FASB should be.

20 We, in the subcommittee, have spent a fair amount
21 of time saying that, if we want to get the best thinking of,
22 not just the FASB, but the SEC, regulators, and others as to
23 what the agenda should be - and probably most importantly,
24 what is the priority, what items should the FASB put most of
25 their effort behind? How do we accelerate getting done those

1 things that everything would say is a high priority?

2 And we thought that having a very active advisory
3 agenda committee could really help in that. And we certainly
4 need to talk a lot more about who is on that. We certainly
5 had a very active discussion about, in any way, does it
6 actually set the agenda and then FASB has to follow it. I
7 think, to that, we said no.

8 But I think the whole intention here would be to
9 get principal participants very actively engaged in saying,
10 "This is the agenda. These are the priorities," and it
11 enables, hopefully, the energy of the FASB to be directed to
12 those things that are critical.

13 It becomes very important because, later on, one of
14 our hypotheses here is that we would like to see most of the
15 authoritative standard setting coming out of the FASB. So,
16 by definition, you need more active help in managing their
17 agenda, if you are going to say, "We would like you to be the
18 primary body of authoritative guidance."

19 But the first recommendation is about setting out
20 some type of formal agenda committee on an advisory basis to
21 help with the setting of the agenda.

22 MR. POZEN: David, in the interest of time, could
23 you go through all the parts in this section, and then
24 discuss them together.

25 MR. SIDWELL: On page 6, you then see some of our

1 views, in terms of our giving some help to the FASB on how to
2 prioritize. And, obviously, this does change significantly,
3 if there is a drive towards international standards. That
4 clearly has to go without saying. But, obviously, there are
5 other recommendations coming out of this committee that
6 should also take priority.

7 A lot of the emphasis and discussion we had in the
8 committee is how much effort the FASB is putting on looking
9 at and correcting things that are already in existence and
10 how much energy is directed towards these things.

11 We actually felt that, between ensuring that the
12 convergence efforts continue, that the codification efforts
13 continue, the conceptual framework is actually completed,
14 that there is a fair amount of work that we think is fairly
15 important to be on the agenda for a while.

16 And we do encourage the FASB, as part of that, to
17 -- I addressed this a little bit earlier; it's point 5 of
18 that Hypothesis 3 - that there should be a section in this
19 codification project to really look at what redundancies
20 should be removed, what complexities should be removed. I'd
21 say this is an area where getting rid of industry-specific
22 guidance would fit.

23 We also believe that it isn't just the standards
24 that should be looked at here. It is the huge body of effort
25 around disclosures.

1 I started addressing the FASB. We then continue
2 that on the top of page 7, saying that it would be good to
3 have a much - in that effort, for the SEC to participate. So
4 instead of, again, codification being a compilation, that the
5 FASB and SEC work together to integrate, where appropriate,
6 the guidance that the SEC and the FASB have given.

7 And, similarly - and I think the point earlier
8 raised this - there is a huge amount of duplication of the
9 companies in their disclosures. So we think there is a huge
10 amount of progress and benefit that can be made from, in a
11 way, using the rear-view mirror to get after whatever
12 guidance is already out there and really change the way that
13 it operates.

14 MR. COOK: Just a question before you get too far
15 away from page 6 on the notion about the agenda committee. It
16 raised a question: Does FASAC not exist anymore? Because
17 this has so many attributes that are common to that.

18 But setting that aside, I just would like a
19 clarification on item 3 about the super-majority. Are we
20 talking about a super-majority of the Board members?

21 MR. SIDWELL: Of the FASB, yes.

22 MR. COOK: Of the Board members.

23 MR. SIDWELL: Yes.

24 MR. COOK: This agenda committee would be an
25 advisory committee --

1 MR. SIDWELL: Yes.

2 MR. COOK: -- and the Board would still have the
3 authority to decide what goes on its agenda.

4 MR. SIDWELL: That's our current thinking. And we
5 did try to contrast what we were talking about here - it's
6 not in the paper, but in one of our meetings - between FASAC
7 and what we're talking about here.

8 And I think we're talking here about something that
9 meets regularly, is very much in the flow of the types of
10 issues that are being seen by the SEC, the types of questions
11 that the FASB staff are getting, and is much more willing to
12 say, "This is an area that we need to prioritize" and get
13 EITF to deal with, get the FASB staff to deal with, or
14 potentially, where the SEC say themselves, you know, "We
15 can't wait for you to do this. We want to do it ourselves."
16 But there is absolutely clarity about what is getting done
17 and who is doing it. And that was really the intent of this
18 agenda advisory committee.

19 In terms of the way standards then get developed,
20 which is the idea on page 8 - you'll be very clear about
21 what the agenda is, you'll be clear about how you set that
22 agenda - one of the ingredients, then, in developing
23 standards from a process perspective that we think is very
24 important is to try and have much more meaningful
25 field-testing cost benefit analysis done throughout the

1 development of the standard.

2 I think that the way we have talked about this, if
3 look at the development of any standard, preparers, users,
4 auditors spend a huge amount of time, anyway, following what
5 the discussion is. Is there a way that we can link that more
6 holistically, so that you have real learning of, "Well, how
7 will this work in practice?"

8 I think it would address some of the questions we
9 have raised about are there difference, even though an
10 activity may be consistent, that you need to consider by
11 different industries.

12 If you then follow our logic, what we are saying,
13 hopefully, you have - because you have developed a standard,
14 you have been much more aware of the issues that are going to
15 be raised by implementations.

16 But we also think - and this really picks up in
17 terms of page 9 - two other aspects that we think that there
18 would be real benefits from always going back two to three
19 years after a standard is issued and say, "What are the
20 issues that have arisen during that period? What are the
21 types of questions the SEC is getting? When Corp. Fin. Looks
22 at specific items, what are the things they're seeing? Has
too
23 much diversity in practice of applying the rules been seen,
24 so that we need to change some of our guidance so that there
25 is more consistency?"

1 We think that, if you think about that two- or
2 three-year period, in many ways it's an extended
3 implementation period. I have to be a bit careful how to
4 define that because, obviously, the standard would be
5 implemented.

6 But you want to have a period during which it's
7 viewed much more as this is a learning period. This is where
8 we are really trying to define where changes need to be made,
9 where from, the actual application of the standard, there is
10 a real benefit of learning. What non-authoritative guidance
11 has been delivered? What are the accounting firms saying
12 and what are the analysts saying about that guidance?

13 So then, at the end of the period, the FASB can
14 address those issues. Then you move to a period where, you
15 know, the questions are being raised. And then one of the
16 premises that you see here is that, during that two- to
17 three-year period, you would expect to see less restatement
18 activity while, if you like, being consulted on the standard.
19 But then, after a post-implementation period, I think that
20 you would expect to have seen the rules really be better
21 understood.

22 I do want to say, against all of that, I don't
23 think we are any way recommending that there is a move away
24 from, if the SEC sees any specific registrant matters, that
25 that process be changed. I think we are talking here about

1 broadly applicable guidance, as opposed to
2 registrant-specific standards.

3 MR. POZEN: Let me just emphasize that I think that
4 this is a pretty far-reaching proposal. It's really saying
5 that you can only know so much in the proposal period, and we
6 really learn how these standards operate when they go into
7 practice. And it takes two or three years before the kinks
8 are worked out.

9 And maybe the subcommittee's view was, one way to
10 put sort of maybe less freight on the whole process by which
11 you sort of try to come up the right answer is to
12 realistically view this three-year period - whether it's
13 called a transition period or something - which would
14 involve perhaps more flexible standards for restatements,
15 more flexibility in the enforcement process - these sorts of
16 things - as these things got worked out.

17 So I think that would be a quite a different
18 approach than is taken now, and I think people should have a
19 chance to react to that, as well as the other points that
20 were made in this very good presentation here.

21 Ed?

22 MR. NUSBAUM: First of all, I strongly support all
23 the movement towards the practical field-testing, the testing
24 after the standards are done, continuing to monitor. I
25 think, all - and I know that the FASB tries to do that, the

1 Board tries to do that, but it's very difficult.

2 And so any means we can use to improve the
3 practical testing, both before and after the standard is set,
4 I strongly support.

5 I think, with respect to the agenda committee,
6 probably the last thing Bob Herz wants is another committee.
7 But I do think it has some merit, and I would extend it, not
8 just to look at the agendas, but also to look at the projects
9 and sort of maybe serve as an independent project management
10 oversight committee, as well as agenda committee, because I
11 think the more people you have looking at the project
12 management and the hurdles and the roadblocks to getting the
13 various 41 or other projects done and overcoming those
14 hurdles, the better off we all can be.

15 MR. POZEN: John White?

16 MR. WHITE: Is there evidence that restatements
17 come during the implementation period of new standards -
18 which I think is underlying what was just said? I just
19 didn't know that there was evidence of that.

20 MR. COOK: I think it might depend on how you
21 define a standard. There is a lot of restatements that come
22 from people changing GAAP, but often that's not the FASB. I'm
23 not trying to be evasive. It's somebody's interpretative
24 GAAP, and that has caused restatements because that's not the
25 way it has been applied.

1 I don't think the FASB is the principal source of
2 that. I think it's other participants, and that is discussed
3 elsewhere in the papers, as well.

4 I think restatements happen because people have
5 different views about things that are out there - maybe more
6 so than new pronouncements. I think new pronouncements would
7 not tend to do that.

8 MR. SIDWELL: And I think the cause here was that
9 we would like to have this be a much more interactive
10 process. So, for instance, if Corp. Fin. Is seeing things on
11 a registrant basis which really are broadly applicable, that
12 there is very active feedback flow, that the FASB would
13 address that issue very quickly.

14 MR. KROEKER: An example might be Statement 157 that
15 the FASB just issued on fair value. Many are concerned that
16 there are open questions and fear that, if they get smarter
17 in terms of how they apply that standard, somebody will come
18 in and say, "Well, you got smarter. You should have known
19 this when you adopted it."

20 Sitting in the subcommittee meeting, that was part
21 of the discussion - if you can take that pressure off of
22 getting smarter, if you will, when you adopt a new standard
23 that is fairly, you know, broad-based.

24 MR. POZEN: I think, John, you are probably right.
25 It's not really a restatement issue. It's really people

1 looking for more concrete guidance as these things are
2 initially applied and trying to build a little flex and
3 feedback into the system, so that people will view this as
4 more of a sort of a collective working out, rather than an
5 adversarial process during these first years.

6 MR. WEATHERFORD: I think a good example of where
7 this has been used successfully is Section 404, where we went
8 from Auditing Standard 2 to 5, where we did get feedback, and
9 the rules were changed. And it has been, I think, a
10 successful effort.

11 MS. BIES: Yes. I think this is a really important
12 recommendation, in terms of, you know, going back and looking
13 after two to three years, especially if we really want to
14 consider moving more to principles-based accounting.

15 When you go into, whether it's a new standard or
16 changes in standards, a lot of times, the preparers and the
17 users need time to understand how the standard works under
18 different kinds of activities or different circumstances.

19 The more we go to judgment-based types of
20 accounting, there is going to be a range of results that all
21 could be reasonable, given the assumptions that are used. And
22 I think there is anxiety in the early periods that we want to
23 build that common understanding of how to apply any new
24 standard.

25 And I think a two- to three-year time frame is long

1 enough for folks to get comfortable with it, see it applied
2 in different circumstances, and be able to provide meaningful
3 input back to the FASB on the issues and allow us to sort of
4 do sort of a fatal flaw kind of review down the road or
5 clarify the issue through some process that - you know, when
6 I was on EITF, very often saw issues that, you know, you
7 would scratch your head and say, "Why is this coming to the
8 EITF?" It was either very narrow - but you realized that it
9 was important to a certain group of people.

10 I think the statement this committee made on page 4
11 about reasonable judgment is very important. And that's why I
12 like this concept of looking back after two to three years on
13 anything new. I think it supports this reasonable judgment
14 and would support a principles-based approach.

15 MR. POZEN: I have Phil and then Denny and then Joe
16 and then Scott and then Jeff.

17 MR. LASKAWY: Just speaking for the international
18 community that I am representing here, we, obviously, are
19 very interested in this area. And, as David knows very well,
20 we are very focused on these same types of governance issues.
21 So, convergence aside, we are very anxious to see what comes
22 from this.

23 But we just, literally, adopted this
24 post-implementation review, which we're going to do on every
25 new substantive standard that we issue after two years to get

1 feedback and determine whether there are changes that are
2 necessary.

3 So we think it's a wonderful idea, so I just urge
4 serious consideration of that.

5 MR. POZEN: Thank you. Denny?

6 MR. BERESFORD: I think it's important to keep this
7 in context so this is sort of a package deal. And we want
8 there to be some sort of guidance on reasonable judgments,
9 and things of that nature.

10 But the tone of the last several comments would
11 lead me to believe, or would perhaps would lead people to
12 infer that this three-year period would lead to lots and lots
13 and lots and lots of additional guidance.

14 That's not what we have in mind. I think we have
15 in mind that these things can be talked out and, in practice,
16 we would be willing to live with some reasonable differences
17 of opinion on some of the things, as long as it didn't get
18 too far out of hand.

19 We want them to be reasonable, but we don't think
20 that we need 800 pages on derivatives, for example, or to
21 answer every single question about 157, or whatever it might
22 be. Getting that in the right balance is obviously the key
23 to this.

24 MR. POZEN: Thank you. Joe?

25 MR. GRUNDFEST: With all respect to Thom and the

1 observations with regard to AS2 and AS5, I really don't think
2 there is anything at all successful about -

3 MR. POZEN: I think we ought to defer that subject.

4 MR. WEATHERFORD: We'll talk offline.

5 MR. GRUNDFEST: We will do that offline. But, just
6 very briefly, you've got to look at this whole process in
7 terms of the system. You can have a situation where there is
8 a great idea at the FASB and the standard setting level, but
9 then you look at what happens as you feed it out into the
10 process and what are the natural profit-maximizing incentives
11 of all of the participants in the process, and with all of
12 the best intentions in the world, you can create a monster
13 that you will never be able to get back into the cage. That's
14 what has happened before.

15 MR. POZEN: Scott?

16 MR. EVANS: I just wanted to emphasize something
17 that we do have in the paper. From a user's perspective, you
18 want to watch comparability, and you want to make sure that
19 this flexibility that we introduce doesn't come at the
20 expense of comparability.

21 And, quite the contrary, we think that, if we
22 introduce enough flexibility, enough informal discussions in
23 studying the issues, that, by actively managing
24 comparability, we can get to a more uniform place than the
25 current process gets us to.

1 MR. POZEN: Jeff? And then Bob.

2 MR. DIERMIER: Just quickly - and I'm not trying
3 to make Bob Herz' life better, but -

4 MR. POZEN: We wouldn't want to do that.

5 MR. DIERMIER: No. You might consider the
6 governance issue of the post-adoption reviews actually being
7 done by an independent group, not part of the FASB.

8 MR. POZEN: That's an interesting idea. Bob?

9 MR. HERZ: I'm going to throw out an equally
10 radical idea, but I think you might want to look at how, in
11 certain other countries, they've had like what they call a
12 financial reporting council. The U.K., Australia - now,
13 those aren't great examples anymore because they're going to
14 IFRS, but they used to have something like that, and they
15 still have it.

16 It intertwines the accounting standard setter, the
17 auditing standard setter, the equivalent of the PCAOB, the
18 SEC regulator, probably the bank guys in our environment, to
19 kind of say, "Okay. Let's look at the whole issues
20 holistically of our reporting system," which is what this
21 committee is doing. So it's almost like perpetuating
22 something like this committee a little bit.

23 MR. POZEN: You think we should have a permanent
24 committee that should just be -

25 MR. HERZ: Yeah. And I can go part time then. But

1 I think there is a lot of promise in that idea, but I think
2 it's kind of a view of looking at the system holistically,
3 not just the accounting standards and not - because all
4 these things kind of are interconnected.

5 MR. POZEN: We are going to have a comment from
6 Con, and then I'm going to ask David to continue on to page
7 11.

8 MR. HEWITT: Bob and the committee members, I would
9 like to just point out, you can have a perfect accounting and
10 auditing standard, but if the implementation is lousy, you
11 have a lousy standard.

12 And on any new standard, it takes a lot of training
13 and change in behavior and understanding to implement that
14 standard. So the transition - something has to be done to
15 provide some time to do this and make sure that standard
16 really works.

17 MR. POZEN: I think that is what this subcommittee
18 is trying to grapple with through having this transitional
19 period, having a review after a few years, and trying to
20 improve that. So I think it's very much on that wavelength.

21 David, do you want to talk now about proliferation
22 of accounting interpretations?

23 MR. SIDWELL: You can tell by our choice of words
24 we have a judgment that was a proliferation of issues and
25 mutual interpretations.

1 I think the main thrust of this next body is to say
2 let's try and be much crisper about what is authoritative and
3 what isn't. And we start by saying, obviously, the
4 codification project enables the FASB, at this point, to draw
5 a pretty good bright line around what they think is
6 authoritative or not, as we talked about earlier. It would
7 be very useful to loop the SEC into that, so that there is
8 one body of codification of FASB and SEC, and there's really
9 a refreshed outlook.

10 MR. HERZ: The SEC are going through a process to
11 put their stuff into the codification. It's going to be by
12 topic and separated because our standards apply also to
13 private companies. But they're going through an internal
14 process to figure out, of their stuff, what they believe
15 needs to be put in there.

16 MR. SIDWELL: I think I'm framing maybe this next
17 step, which is to make it a more integrated approach than
18 just separate sections. And, obviously, this is early days
19 of codification, but I think we are saying the more
20 integrated guidance can be, the clearer it will be for the
21 users.

22 A lot of this is premised on the fact that the
23 principal place we would like to see authoritative accounting
24 guidance come from is the FASB. And, by that, we also mean
25 the EITF, to the extent that it is delegated. To the extent

1 that the SEC has registered specific matters, obviously, that
2 process should continue. We think that is the right
3 approach. But to the extent that there are rules that need
4 to be disseminated more broadly, that should be primarily
5 done by the FASB.

6 We, however, recognize that you have to be
7 pragmatic. There may be some items that the FASB doesn't
8 want to take on, and that, through this agenda setting
9 process, there is agreement that it would make a lot of sense
10 for the SEC to go ahead and issue guidance. And we would
11 just encourage that that follow a due diligence process in
12 the same way that the FASB does.

13 That makes sense if you like a body of
14 authoritative guidance. We then believe that everything else
15 is not authoritative and that it shouldn't be that making a
16 speech, or by one of the accounting firms issuing guidance -
17 that that should be viewed as any more preferable to
18 something that is documented, well-reasoned from an
19 individual registrant.

20 And I think, again, the whole process of this
21 feedback loop is, to the extent that there is divergence
22 occurring in implementation, to use Con's term, that this
23 whole agenda process is designed where, if it gets to a point
24 that it is viewed as unacceptable, then it is addressed.
25 So a much more active dialogue on what is actually

1 happening in practice and that immediately causing a
2 discussion of who should deal with it and how it should be
3 dealt with.

4 This is clearly a big change from where we are, in
5 terms of, really, separating authoritative and
6 non-authoritative. And, obviously, I don't think in any way
7 are we saying that it's not hugely useful for things like
8 firms to put out their interpretation, their help. All that
9 is useful. We just don't think it should take the stature of
10 being viewed as more authoritative.

11 MR. POZEN: Maybe there should be a warning label,
12 "This is not authoritative guidance."

13 So I think these are well laid out by the committee
14 on pages 11, 12, 13, and 14 on interpretative guidance. So
15 do we want to have any commentary on that? Ed?

16 MR. MCCLAMMY: I agree with - in fact, I thought
17 this whole section coming from the committee was extremely
18 well laid out and thought through. I agree with all of your
19 recommendations.

20 On the point of the clearance within the SEC, on
21 the single point, I agree with that. It may have been
22 contemplated, but I think should be clear that it should also
23 come through one common medium, as well. And it shouldn't
24 come through speeches. There should be some formal way of
25 here is how it gets put out to the preparer and the user

1 communities.

2 And I almost think of it as like FD for companies;
3 that you wouldn't want that going out and saying, "Well, you,
4 investor, go find it." It should come out through one
5 source. So if it's going to go out in a speech on a day, it
6 should also go out through a standard mechanism, so people
7 don't have to be aware of that speech to know what the SEC is
8 thinking.

9 MR. POZEN: Yes, Ed?

10 MR. NUSBAUM: I also agree with the
11 recommendations. I think they are excellent.

12 I think we have to be careful, though, to make that
13 we allow the accounting firms, and even like the AICPA, which
14 answers questions for a lot of the smaller firms and smaller
15 companies out there, privately helping them - I wouldn't
16 want to shut that off, but make sure that it is clear this
17 it's not authoritative and all that guidance does not cover
18 everyone.

19 MR. SIDWELL: Can I just ask Jim Quigley if he has
20 anything to add on this because this was an area he felt very
21 strongly about.

22 MR. QUIGLEY: Thank you, David. I just want to
23 emphasize the points that were made on pages 2 and 3 before
24 we get to proliferation of standards.

25 And that is, I think the root cause analysis of how

1 we have gotten to where we are has been driven in large part
2 by this fear of second-guessing or having a conclusion
3 challenged, and then a restatement occur and then have that
4 cascade through the system.

5 And if we could actually get to the point where
6 there was a meaningful judgment framework and that that
7 judgment framework could become part of the basis of the
8 test, I think auditors and preparers would be less prone to
9 go to various bodies and ask for a bright line rule that
10 would then provide a basis of defense.

11 Because if we have this judgment framework, we
12 could then have a basis of defense. And then all of the
13 recommendations that are laid out could improve the financial
14 reporting process.

15 And I think, without that judgment framework, it is
16 very difficult - this proliferation that we deal with and
17 that we label as one of the sources of complexity, it's
18 difficult to see an environment where that goes away, because
19 it becomes the basis of defense, it becomes the basis of
20 survival, and it becomes the document on which we end up with
21 an obsession with compliance and trying to run down all of
22 these various forms of guidance that are out there.

23 So I think that we could take a big step forward,
24 but the underpinning of that judgment framework and then
25 having that be able to stand is really critical to be able to

1 move forward with these recommendations.

2 MR. POZEN: Thank you, Jim.

3 MS. GRIGGS: I just want to echo Jim's view. I do
4 think judgment is necessary and the framework will be very
5 helpful in this area.

6 I also want to just caution - you know, the SEC
7 staff gives a lot of guidance because registrants ask for it.
8 And when the staff sees that there is an issue that should be
9 brought to the attention of other registrants, it may not be
10 appropriate to go through a formal process. It may be more
11 helpful for there to be a more expedient way for that
12 communication to then be known.

13 So while I think formal processes are important, in
14 some cases, we really don't have the luxury of that. So I
15 just want to hesitate to try to restrict the staff because I
16 know that the staff provides a very helpful role to
17 registrants working out issues.

18 MR. SIDWELL: I think, just to use that as an
19 example of what we were contemplating here, that is where, if
20 done properly, this agenda committee could be very useful
21 because it meets regularly enough, and that becomes a
22 sounding board for any proposed practice items that the SEC
23 is seeing. And it's just where, "We think we need guidance
24 on this. Are you going to do it?" FASB says no. "We're
25 going to go ahead with this. Is everyone on board? Let's go.

1 Are we missing anyone?"

2 It's really actually - it sounds formal, but I
3 think the goal would be that it's much more timely in just
4 getting everyone on board with the guidance that is given.

5 MR. POZEN: There aren't any more comments on that
6 area, so I think we might move to design of standards on
7 pages 14 and 15.

8 MR. SIDWELL: Yeah. I feel this, at this point, is
9 a little bit motherhood and apple pie, in terms of,
10 obviously, if you move to the point where there is more
11 recognition of professional judgment along the lines that Jim
12 just spent time talking about, we do think, in the design of
13 a standard, there are a number of premises that we think are
14 important that are laid out on page 14, under Hypothesis 21.

15 Obviously, I think there will be a huge interaction
16 with some of the other groups as we develop this, in terms of
17 bright lines, safe harbors, et cetera. So this is really
18 just preliminary thinking, that we do think it would be
19 useful to try and continue to develop the idea of what is an
20 ideal standard, and some of the thoughts that we have are
21 laid out here in detail until we come to the time to develop
22 these.

23 MR. POZEN: Do we have anyone who wants to comment
24 on that? I think we probably pushed that around. And then
25 international considerations is, I guess --

1 MR. SIDWELL: We dealt with that at the beginning.

2 MR. POZEN: Well, I think maybe we ought to just
3 take a short break for 10 minutes or so, and then we will
4 come back and do Subcommittee III. Does that make sense to
5 people?

6 COMMITTEE MEMBERS: (Nodding.)

7 MR. POZEN: Okay. Why don't we do that. Thank you.

8 (A break was taken from 11:40 a.m. until 11:50
9 a.m.)

10 MR. POZEN: We are going to start here and go
11 through Subcommittee III, and then we are going to take a
12 break for lunch. And then we will come back and do
13 Subcommittee IV afterwards, and then leave us a little time
14 at the end to discuss where we go from here. So we are
15 slowly gathering here.

16 We are now at the Audit Process and Compliance,
17 Subcommittee III. And I'd ask Mike Cook, as the subcommittee
18 chair, to lead off.

19 MR. COOK: Thank you, Bob. I was going to just say
20 this is the point at which you thank everybody who has helped
21 you, and that would like take a long time to do that. And I
22 was surrounded by committee members until Greg ducked out,
23 but he's coming back.

24 We have a great committee - Ed and Greg and Linda
25 -- working on this. We have great staff support. Thank you.

1 I would mention Bert Fox, who is very new to the SEC, came to
2 that position - I think he was there one day before he took
3 over our first subcommittee meeting. He has done a great
4 job. So everybody else will have to live with the Academy
5 Award sort of you-know-who-you-are kind of a thank you. But
6 Bert, thank you. Great job. And we do appreciate it.

7 MR. POZEN: I think we should say that each of the
8 people working with the subcommittees has been excellent.
9 Adam Brown and Amy on No. IV and Brett on No. II. And there
10 have been a number of other people - Sharon and Holly.

11 MR. COOK: See, I told you it was - we would be
12 off if we said, "You know who you are," and -

13 MR. POZEN: Okay.

14 MR. COOK: This subcommittee did something that I
15 didn't know what it was until this morning: We chunked our
16 agenda. I didn't even know what chunking was.

17 But we sort of took the scope of our work and
18 divided it into three components, and we have given the
19 highest level of our time and attention to the subject of
20 restatements, with an objective of trying to bring final
21 recommendations to the full committee at our next full
22 committee meeting.

23 And so most of what you will hear about and,
24 hopefully, provide us input about will be the subject of
25 restatements. That is the principal thrust of the paper.

1 We are well aware of the importance of this
2 framework for judgment, and we have given very limited
3 attention to this point. It is the next top item on our
4 priority list, and we will consult with the other committees
5 that have referred this to us or asked us to be sure to do
6 this well, and we will be sure we understand their needs and
7 expectations also.

8 The third phase, which we have not touched at this
9 point, is the issue about compliance and the various people
10 who influence accounting and accounting complexity, including
11 the SEC, the PCAOB, the FASB, the accounting firms. That is
12 the third phase in the process, which we have nothing to
13 bring to you or talk about this morning.

14 The principal topic, as I indicated, is
15 restatements. I won't go into much detail here. What do we
16 know? What have we learned?

17 What we know is there are an awful lot of
18 restatements. There are slightly differing accounts, but
19 take our word for it that, last year, there were about 1500,
20 1600 restatements by 1300 to 1400 different companies -
21 about 10 percent of all the companies of all the registrants
22 having restatements. And in addition to there being a lot of
23 them, they have increased dramatically in - approximately
24 three times what they were five years ago.
25 Restatements are very visible. They have been

1 studied by lots and lots of different folk, from lots and
2 lots of different perspectives. And so we have a lot of
3 input on the subject of restatements in work that has already
4 been done - not for us, but we have tapped into all of these
5 different studies and analyses.

6 We believe restatements are of considerable concern
7 for, essentially, three reasons.

8 One is just the sheer numbers - just the sheer
9 number of 1600 restatements, if you'll accept that number.
10 Why do we have so many situations in which financial
11 reporting is being changed because of errors in the financial
12 reporting previously?

13 Secondly, we think that the number of restatements
14 has a pretty significant impact on the public perception of
15 the quality of financial reporting - the public's confidence
16 in financial reporting. If 10 percent of the companies in
17 the United States, to accept one characterization, can't get
18 their books right, what does that tell you about the level of
19 confidence that you would have in financial reporting? So we
20 need to be concern about it for that reason.

21 And, finally, in our deliberations, we reached the
22 point of saying we have a reason to be concerned, as well, if
23 the number of restatements, the sheer magnitude of
24 restatements, include many of them that are not material. And
25 I'll explain our classification.

1 If lots and lots of them are not material, they
2 have a tendency to obscure the ones that are. And people
3 aren't getting the attention to the items that they should,
4 in terms of restatements, and they are not getting, they tell
5 us, the kind of information that they should be getting to
6 better understand restatements, why they happen, and so on.
7 And the sheer number, again, is overwhelming people's focus
8 on things that really do matter.

9 We all know the definition of materiality is not 5
10 percent of this or 10 percent of that. It's none of those
11 things. Those are surrogates for what people believe would
12 be an investor's judgment - what information would, put into
13 the mix, change an investor's perception about the company,
14 its future prospects, and so on.

15 And so the assumption is that, if we are dealing
16 with items that are material, they are items which influence
17 investor judgment. And our conclusion, based on the studies
18 that have been done and the work that we have done, is that
19 that is not true of perhaps the majority. We don't have a
20 quantification of this, but a large number of the
21 restatements that are taking place today are not material by
22 that definition. They do not influence investors. They do
23 not change market perceptions of companies.

24 Again, studies have been done in the GAO, the
25 PCAOB, and others who have studied market impact. And we did

1 something that - you know, a novel idea. We went and talked
2 to investors and creditors - people who represent investors
3 and creditors, and had a group of them in to talk with us,
4 and it was very revealing to us, and a number of their
5 observations are included in the paper that has been provided
6 to you.

7 But the bottom line of that discussion was
8 confirming the notion that an awful lot of what is in the
9 restatement category today is not material to them. It might
10 be interesting, but they are concerned also about being sure
11 they get the information about the things that really do
12 matter in a different format than they are getting it today,
13 and not getting a lot of things that don't influence their
14 judgment about companies.

15 And why that is - a lot of different reasons. Some
16 of them is because the items are very technical. They are
17 mundane. They are accounting changes that don't affect
18 anybody's judgment about the performance or the future
19 prospects of a company.

20 In some instances, they told us they get a lot of
21 old news. They are getting restatements of things that are
22 years ago - interim periods years ago, which aren't very
23 relevant to their current judgments about the company and its
24 future prospects.

25 So we kind of asked ourselves: At this stage, what

1 can be done to change the situation if, in fact, we have too
2 many restatements and restatements which are not material to
3 investors? And two things come to the top of the list for
4 us.

5 One is we think the people who are making judgments
6 about the need for restatements - registrants, their
7 auditors, the regulators who are being consulted on these
8 subjects, various advisors - need to step in the shoes of
9 the investor and think like an investor as to whether or not
10 this matters, whether or not that is something that is going
11 to change someone's perception about the company in a
12 meaningful way.

13 And we don't believe that that takes place very
14 often today. We think there are mechanisms - and we suggest
15 some in the paper - that could be used by credit and equity
16 analysts to try to get that point of view and have the people
17 who are making decisions about materiality thinking that way.
18 So that is one element of it.

19 The second element of it is a substantial
20 improvement and expansion of the guidance that is given to
21 the various participants in that decision-making process with
22 respect to materiality.

23 Today, the principal guidance - virtually, the
24 only guidance on this particular subject is Staff Accounting
25 Bulletin 99, which has now been codified into some other

1 description, which I don't recall, but just call it SAB 99
2 for the purpose of discussion. A very useful discussion
3 about materiality - it does embrace a number of the concepts
4 that we have here - but, essentially, a single directional
5 guidance.

6 It, essentially, tells people when things that are
7 not quantitatively material become material because of
8 qualitative factors. And there is an extensive discussion
9 about that in that statement.

10 There is little or no suggestion - and, certainly,
11 no discussion - of the opposite side of the equation, which
12 says there are things that may be quantitatively material by
13 traditional measures that are not qualitatively material
14 because they aren't going to matter to the people who are
15 going to be the recipients of that financial information.

16 And what we believe - based on experience, talking
17 to people, and what we heard - is that, almost without
18 exception, something that is defined as quantitatively
19 material today - and we will use five percent of some
20 relevant measure, and you can pick what that relevant measure
21 is; often income - if it's over five percent, it's getting
22 restated. It is being defined, virtually automatically, as
23 being material.

24 And it also is joined by other items which are
25 below that level, which are being brought up because of

1 quantitative considerations. But it is the absence of any
2 judgment being applied above that five percent level to say,
3 "Hey, that might be eight percent, but it really just doesn't
4 matter because - " and there are lots of reasons why you
5 might reach that "because."

6 We tried to illustrate, in part, some of our
7 thinking here by the sliding scale analysis, which is in the
8 paper that you have - a suggestion that we have thresholds
9 above and below which rebuttable presumptions should come
10 into play. If it's something that is less than five percent,
11 there ought to be a rebuttable presumption that it's not
12 material. "Rebuttable" meaning if qualitative factors are
13 compelling that it could be a material item, even if it's
14 less than five percent - perhaps a lot less than five
15 percent, depending on the item.

16 Above 10 percent, the presumption should be that an
17 item is material, and for you to reach a conclusion that it's
18 not, the qualitative factors are going to have to be pretty
19 compelling.

20 And in that 5 to 10 percent range, you get a lot of
21 different circumstances. You're kind of in what we would
22 think would be the gray area and one in which qualitative
23 factors really have to be looked at very carefully.

24 But we do think that is a movement away from some
25 of what is taking place in practice today, but it is

1 representative of an outcome that does fit with this notion
2 of: Think about it like an investor and try to think about
3 whether this is going to matter to them.

4 We also suggest that there is an absence of current
5 guidance, a void which could be filled and would help a lot
6 in this area with some guidance around restatements in the
7 balance sheet, restatements in the cash flow statement,
8 restatements within statements that don't change the bottom
9 line of that particular statement. It doesn't change
10 stockholders' equity, it doesn't change total cash flow, but
11 it might move this line here and that line there. We think
12 some additional guidance there would be helpful.

13 And, finally, we think it would be very helpful to
14 have some current thinking and current guidance on
15 materiality for the purpose of judging restatements in
16 interim financial statements. The only time that has been
17 addressed was in APB 29 - which is older than, at least,
18 some of the people in this room; maybe the majority - issued
19 more than 30 years ago, when interim financial reporting was
20 a whole different ball game than it is today.

21 And what we heard from the folks that we talked to
22 is a general view that interim financial periods should be
23 treated as discrete periods. They should stand alone. They
24 are important on their own, not just in terms of trends, and
25 perhaps the materiality guidance with respect to those

1 periods should be reconsidered and tightened up.

2 We considered - I won't go into it, but we
3 considered whether, you know, some new approach to
4 restatements where they would all be done prospectively and
5 we wouldn't have restatements of prior periods and amendments
6 of filings, and things like that, and concluded that that was
7 not a good answer. It's a clear departure from GAAP today.
8 And we think, in the instance of restatements that really do
9 matter, we would be taking away from the user/investor
10 community information that really is important to them.

11 A more appropriate answer would be to eliminate
12 those which are not material, leave those which are material
13 -- which do require investor focus - and then deal with
14 those retrospectively.

15 Two other aspects of this - three, really. One is
16 just a recommendation we're going make for people to take a
17 look at the current filing requirements, particularly the 8-K
18 requirements - this issue about stealth restatements. Just
19 take a look. There has been some additional guidance issued.
20 Is it adequate? Have we taken away what are characterized as
21 stealth restatements?

22 But we heard consistently that people want to know
23 more about restatements that are meaningful, that are
24 material. When was the error discovered? How was the error
25 discovered? What are the weaknesses - whether or not they

1 are material weaknesses in internal control, what are the
2 weaknesses that allowed this to happen? And, very
3 importantly, what has been done, so this doesn't happen
4 again? What remediation steps have been taken?

5 And the investor group that we talked to felt they
6 really weren't getting that information. They were getting
7 just basic facts and boiler plate and not finding out,
8 really: What happened here? Why did it happen? And what
9 are you doing to be sure it isn't going to happen again?

10 And, finally, we got some very interesting comments
11 that we have reflected also in our paper about what happens
12 when a company discovers an error, and what happens, then, in
13 terms of their continuous flow of information to the
14 marketplace.

15 And, essentially, what we were told is that people
16 just go silent at that point, and that that is very - not
17 well received by the investor community, very disruptive to
18 the marketplace, for somebody to say, "We've got a big
19 problem. We're going to investigate it. We'll get back to
20 you when we know what it is," and they don't hear anything
21 from you for extended periods of time.

22 The suggestion here is that things can be done, but
23 we may need to help people out who are very concerned about
24 the disclosure of uncertain information. But keep the flow
25 of information going into the marketplace during that period

1 of time, when investor concern is at a very high level, and,
2 today, they are blacked out; they are not hearing anything.

3 I'm reminded of the old saying, "While under
4 repair, the store is still open." That is true about these
5 entities. These corporations are operating, and people need
6 to know what is going on - even if you can't tell them yet
7 what the specific outcome of a particular investigation might
8 be.

9 Our desired outcome here - just very quickly -
10 that the people who are participating in the decision-making
11 process around restatements are making better decisions; they
12 are doing it from the perspective of the investor, who really
13 is the one to judge the materiality of these things; and
14 enhanced guidance to help people to do that.

15 We think the end of that will be substantially
16 fewer restatements than we have today, and the ones we will
17 have in the future will be ones that really matter, with
18 enhanced disclosure about the restatement itself and the
19 restatement process to help investors understand what is
20 taking place.

21 So that is item No. 1. Item No. 2 -

22 MR. POZEN: I think we ought to just take -

23 MR. COOK: Take item No. 1. Item No. 2 will be the
24 judgment framework. We'll save that, I'll cool down, and
25 we'll take questions and observations about restatements.

1 MR. POZEN: As usual, Mike has done a brilliant job
2 of summarizing the deliberations on this issue of
3 restatements. But I think there are two very specific issues
4 that I think I would like to get the full committee's view
5 on.

6 One is that the subcommittee debated whether or
7 not, if something was material, maybe it didn't have to be
8 restated, maybe it could have a prospective approach, and
9 decided no, they weren't going to do that. If something was
10 really material, that it should be restated.

11 And then it went on to say that materiality should
12 be viewed as to current investors. And that is a very
13 critical difference, because some things might be material in
14 the past, but no longer in the future.

15 And then third of all, developed this notion that
16 Mike articulated of a sliding scale of qualitative and
17 quantitative.

18 So this is - I mean, there are other issues, but
19 this is a whole framework that the committee has done, and I
20 think we should have some feedback.

21 Denny?

22 MR. BERESFORD: I'm in favor of the general
23 approach that Mike has. I'm not in favor of the interim
24 reporting. First of all, I think it would lead to many more
25 restatements.

1 And I recognize that there is a difference of
2 opinion among accountants - and perhaps users, as well - as
3 to whether the discrete versus integral approach to interim
4 reporting provides the best information.

5 I can make a case for either one. I happen to like
6 the approach in Opinion 28, which is the integral approach.
7 I note that the footnote that was cited in the paper is
8 pretty clear with respect to how you view interim
9 materiality.

10 But I think it would be inappropriate for the Board
11 to take on that as a particular issue without going into the
12 basic premise of interim reporting and perhaps reconsidering
13 coming up with the discrete approach.

14 The problem with the discrete approach is I think
15 that it would take a lot longer for companies to do that on a
16 quarterly basis, and I think it would just be - either that,
17 or they would simply come up with estimates that would be
18 much more problematic on an interim basis and subject
19 themselves to more restatements.

20 So I just think that's one part of the package that
21 warrants reconsideration.

22 MR. POZEN: I happen to agree with you, Denny, on
23 that point, but I think we should have more opinions on that.
24 That's another important issue in terms of reporting.

25 MS. GRIGGS: I don't think we were saying that we

1 disagree with paragraph 28, paragraph, or whatever it is. I
2 think what we were saying was, in the area of interim
3 financials, what we heard some of the investor groups say is
4 that they thought interim financials were very important, and
5 we should not regard them as - just look at the annual
6 period.

7 So I think we are still looking at the impact of
8 errors on interim periods. We were reluctant to - we don't
9 believe that, if errors are discovered in an interim period,
10 you would simply consider those with reference to the annual
11 period and not fix them. We thought errors, generally, that
12 are discovered in a particular period affecting that period
13 should be fixed.

14 But it's historical errors that apply to a prior
15 interim period that we really thought we had to look at the
16 current investors' need for that information. And depending
17 upon when that interim period occurred, it may not be
18 appropriate to restate because it would not be relevant to
19 current investors.

20 MR. POZEN: Well, just to say - a different
21 viewpoint is, to the extent that we want people not to focus
22 that much on quarterly earnings, if we are judging the
23 materiality of an error relative to that particular quarter,
24 rather than the year, you are sort of encouraging people to
25 try to manage those quarterly earnings. And I guess I'm of

1 the view that I'm more interested in the impact of the error
2 on the annuals.

3 So that is a different, I think, point of view. I
4 agree all errors should be corrected. But the question of
5 whether an error in a quarter that would be immaterial for
6 the year should need restatement - which, if I understand
7 Denny, is what he was teeing up - I think it's a legitimate
8 debate.

9 MR. COOK: Bob, I don't think we're - we're not
10 going to, you know, write this guidance. We have the luxury
11 of being able to recommend that people issue guidance and
12 then go home. So we aren't going to write it. And there
13 needs to be more work done, I'm sure, before that particular
14 issue, or some of the others, get wrestled to the ground.

15 But what we heard - and we didn't have an
16 extensive sample - what we heard from the investor community
17 -- equity analysts, in particular - saying is that, "These
18 quarterly periods are really important. And we use them for
19 comparability."

20 We asked the question about, "Well, why would you
21 bother to go back and restate last year's second quarter?"
22 "Well, last year's second quarter is being put up next to
23 this year's second quarter, and those are in the annual
24 reports every year, and we need that information to be as
25 best it can be comparable" - as to material items; as to

1 things that matter to the investors. And they were quite
2 consistent in that point of view.

3 So, you know, one of the problems you have when you
4 ask users for their point of view, you have to listen to what
5 they tell you. And we did listen to what they told us, and
6 what they told us was those really do make a difference.

7 And they didn't say that every item has to be
8 measured by its materiality in a quarterly period, nor would
9 we suggest that. But it isn't just - it wouldn't matter on
10 an annual basis and, therefore, it doesn't need to be fixed
11 in the quarter would not be, to them, an acceptable answer.

12 MR. POZEN: I have Jeff and then Peter.

13 MR. DIERMIER: I think Mike did a very good job of
14 describing how I think most of the folks that I know would
15 feel about this. I tend to be more like Bob. I think things
16 should be viewed more on an annual basis.

17 And maybe a good intellectual construct, in terms
18 of the way you think about this is, even when people are
19 looking at their year-to-year comparisons on a quarterly
20 basis, or whatever, in their mind, they are always kind of
21 working on an annual run rate number. Okay?

22 So they are thinking about, you know, the
23 annualized run rate earnings, or cash flow of the company. So
24 it might help you for scaling purposes. So sure, they care
25 about the quarters, but, really, you can intellectually gross

1 that up, if you're trying to think of how material something
2 is.

3 MR. COOK: Again, Jeff, to the point you just made,
4 I don't think we would suggest that we know what those
5 judgments are. And some of the thoughts you just expressed
6 is what we think should be part of that process - the
7 thought process.

8 MR. POZEN: Peter, did you want to say something?

9 MR. WALLISON: Yeah. Just this: It seems to me
10 that the problem here is, as you mentioned at the beginning,
11 a problem of complexity. And if we can solve the problem of
12 complexity, we can solve a lot of the reasons for all these
13 restatements - complexity plus my old friend liability.

14 As I understand what happens within companies that
15 results in restatements is that the accountants have
16 reviewed, in their central office, something that has already
17 been approved and published, and they change their view on
18 how something should be treated because of something that
19 came up in another jurisdiction, in any other company. They
20 decide, "Well from now on, we are going to have to treat this
21 differently."

22 And the accountants then go back to their clients
23 and they say, "Well, we have a different view now of your
24 financial statements. You should restate them now." And one
25 of the reasons that accounting firms are doing that is that

1 they are so afraid of liability.

2 And so until complexity is eliminated, so that
3 there is a much more reasonable way that accountants can make
4 judgments about what is the proper treatment of something -
5 and preparers, too - it will be very hard to eliminate the
6 underlying causes for wanting to restate.

7 And then the pressure to restate is coming from the
8 fact that there is substantial liability on accountants and
9 on companies for failing, in hindsight, to have made a change
10 that some investor or investors might claim was responsible
11 for what they did.

12 I think the issue of materiality is really
13 inequitable. I think it's very, very hard to make a judgment
14 about what is material in a given situation. I favor looking
15 at the underlying causes for it, rather than looking at the
16 question of materiality as the solution.

17 MR. POZEN: I think we have Joe and then Ed.

18 MR. GRUNDFEST: Four very brief points. The first,
19 I'm not exactly persuaded that the quantitative tests of
20 materiality are really the driver of the problem here. I
21 think the qualitative factors are every bit as important.

22 For example, I think John said that all errors
23 should be corrected. And if you stop and think about it in
24 that way, once you know something is a mistake, if you read
25 SAB 99 very carefully and focus on the qualitative elements

1 of materiality, you then have a hard time, in effect, saying,
2 "Well, let's go out and let's put out our historical data,"
3 and we go back three years, when we know that something is
4 wrong. Okay? So I think you do have to look at the
5 qualitative, as well as the quantitative factors.

6 Second, we can and must do a better job with regard
7 to the 12b-25 issue, in terms of potentially listing and not
8 being able to put out financial reports, and what have you.

9 We've got to give a safe harbor, so that we can
10 allow people to say, "Look, we have found a historical
11 problem. We are spending unconscionable amounts of money
12 moving decimal points around, with armies of auditors. We're
13 going to try to get this figured out as quickly as possible.
14 We're warning you about this. Here is our best stab at our
15 current quarterlies, all right, and we are not taking any
16 liability, and we're not going to have any liability with
17 regard to the stuff that we're telling you we've got to fix."

18 All right. That is something the SEC can and
19 should do immediately because it will leave everybody in a
20 better situation.

21 Third, the part of the restatement process that, in
22 my experience, hacks off the issuers more than anything else
23 is what the iatrogenic restatements - the restatements that
24 are like iatrogenic diseases, where you go, you see a doctor,
25 and it's the doctor that makes you sicker. All right? That's

1 an iatrogenic - you go to the hospital, and you come out
2 with an incurable infection from stuff in the hospital that
3 you didn't have before you went in.

4 It's when you go, and the auditor comes and he
5 says, "Well, you know, you the way we." Look - and I'm not
6 making this up - a company says, "Gee, we think this is the
7 right accounting. Let's go ahead and do it this way." The
8 auditor then says, "No, no, no, no, no. We've got to do it a
9 different way."

10 Two years later, the auditor comes back and says,
11 "You know, we're going to restate, and we're going to make
12 you do it the other way." The company says, "Well, that's
13 how we wanted to do it originally." And, "Well, you know,
14 the partners change," whatever it is, "We don't remember that
15 conversation," or, "That's not exactly what the e-mail says."

16 But, now, you're going to be spending millions of
17 dollars to do the restatement, to do it the way you wanted to
18 do it in the beginning. And, meanwhile, the world thinks
19 that you are a bad reporting company, when it's what you
20 wanted to do, to begin with, and the auditor is sort of
21 running around going, "You see, I'm cleaning up the books."
22 And you're sitting there going, "No, it's exactly the
23 opposite."

24 If you want to know what hacks people off, all
25 right, behind the scenes, and they can't really talk about it

1 that way - and Bob is shaking his - let the record show
2 that the head of FASB is shaking his head in a vertical
3 direction, like a bobble-head doll, agreeing with me, okay?
4 These are the worst case examples, all right, of what goes on
5 behind the scenes in a restatement.

6 It is not true that, when a restatement happens, it
7 means the company made a mistake. It happens sometimes that
8 a restatement happens because the auditor changed his mind.
9 The company had it right all along, all right, and it is now
10 spending a lot of money and having its reputation impugned
11 because of that. Otherwise, again, it's fine.

12 MR. POZEN: Thank you for that spirited - we have
13 Ed and then Scott.

14 MR. MCCLAMMY: That's hard to follow.

15 MR. POZEN: Yeah, it is hard. Joe is hard to
16 follow, no doubt about it.

17 MR. MCCLAMMY: Yeah. I just wanted to say I agree
18 with Denny' comments totally. And I think we need to
19 remember that, if we make this change to looking at
20 materiality on a quarterly basis, then, just mathematically,
21 we are increasing precision level by a factor of 4. And I
22 think that this committee has already acknowledged that there
23 is already too high of a perception of precision within the
24 financial statements. So I think we are headed in the wrong
25 direction.

1 MR. POZEN: Thank you. Scott?

2 MR. EVANS: I wanted to applaud the subcommittee
3 for attempting to view materiality through the eyes of the
4 investor and the user because I think that's critical. It's
5 a difficult thing to do.

6 I think the idea that we have more transparency
7 about the process of discovering restatements, about
8 understanding how they occurred, what sort of control
9 weaknesses are there will bring out into the open the type of
10 stuff that Joe was referring to, if that, in fact, is all
11 that is going on in the process. The more that investors
12 know about the nature of the restatement, the causes of the
13 restatement, when they are material, the better off they will
14 be.

15 I worry that some of the solutions being proposed
16 still resemble bright lines a bit in the sliding scale, and
17 so forth. But I think the progress is definitely in the
18 right direction.

19 MR. POZEN: I think that, while a rebuttable
20 presumption has some element of a bright line, I think it
21 does provide enough flexibility that I'm not sure I would
22 quite call it a bright line.

23 Ed?

24 MR. NUSBAUM: I just want to follow up on a couple
25 of things. First of all, I think it's clear that I don't

1 think we, as a subcommittee, have reached any final
2 conclusions on the interim materiality, and so I think this
3 input has been very helpful.

4 We did do a fairly comprehensive look at
5 restatements, as well as the experience of those of us on the
6 subcommittee, and I would say that some of the reasons for
7 restatement that have been described are certainly true and
8 accurate, but there are a lot of different reasons for
9 restatements. There is no single reason. In fact, there are
10 many different reasons - that your CFO might find something,
11 your controller.

12 Companies frequently find the restatements
13 themselves, the auditors find them, there's some change in
14 complicated accounting rules, as well as the situations that
15 Joe described, and others.

16 And I think one of the things the subcommittee has
17 to do going forward is to look at whether or not the
18 recommendations will have a significant effect on the number
19 of restatements and whether the recommendations are
20 practical. And that's something we intend to look into.

21 MR. POZEN: Bob?

22 MR. HERZ: This may be completely tangential, but
23 I've always kind of wondered - you know, this morning was
24 employment report day, okay? So employment data comes out.
25 The market runs around and it says, "Terrific," whatever,

1 and, "Oh, by the way we adjusted this month's employment
2 data."

3 Or the quarterly GDP numbers come out, and then,
4 the next month, they adjust them by fairly significant
5 amounts, potentially, yet, the whole market has reacted - on
6 a very short-term basis, at least - to those kind of macro
7 numbers.

8 And I have always kind of wondered: What is so
9 different about those things that drive all of the market
10 versus these company-specific things, where we demand, you
11 know, kind of -

12 MR. POZEN: The Bureau of Labor statistics cannot
13 be sued in a class action lawsuit for getting the employment
14 numbers wrong.

15 MR. HERZ: But why is it the system works with that
16 and doesn't work, you know, in a way that works around
17 financial statements?

18 MR. POZEN: Well, I don't know if that - that's a
19 whole different question. I have a little experience in
20 Social Security with government accounting on a cash flow
21 basis, you know. If we did that in our pension accounting,
22 we would be way, way off.

23 So I think, for better or worse, there are
24 different norms. I'm not sure we will get much further than
25 that.

1 Yes, Joe?

2 MR. GRUNDFEST: Well, on the different norms, you
3 know, Bob's point, I think, is actually more profound than
4 even he realizes because -

5 MR. HERZ: I don't know if that would be possible.

6 MR. GRUNDFEST: -- because the market has different
7 expectations. All right? And, you know, when you say that,
8 "Gee, you know, 10 percent of companies have restatements,"
9 you mean 10 percent of companies can't get their books right.

10 Well, I think that's as much a negative reflection
11 on whoever it is that made that statement as it is on the
12 restatement process, because, if we come to understand that
13 accounting is, by nature, an imperfect process, even if well
14 done, all right, you expect that, in a reasonable percentage
15 of situations, you will go back after the fact and you'll
16 say, "You know, it would have been better if we would have
17 put this number here and that number there, but we didn't see
18 that at the time."

19 And it doesn't reflect incompetence. It doesn't
20 reflect fraud. It just simply reflects the natural
21 imprecision of the process.

22 So I do think that a piece of what is going on
23 here, I hate to say, is a marketing problem. All right? The
24 idea that, you know, people scream about there being so many
25 restatements, when many of them are technical adjustments.

1 Maybe part of the challenge here is to find another
2 word, other than "restatement," whether everything appears to
3 have the same order of magnitude. Maybe we call some of
4 these things technical adjustments, amplifications,
5 refinements. Okay? Just enhancements. Features, as we say
6 in the software world, rather than bugs. That might be the
7 way to go.

8 MR. POZEN: Okay. Well, I think it seems that
9 there is a consensus that the subcommittee's approach to
10 current investors, and a sliding scale, and other things,
11 having a combination of quantitative and qualitative, seem to
12 be well accepted. I think there is an issue on interims, and
13 if you'll look at it.

14 I do want to, before lunch, leave time to have this
15 discussion of a framework for professional judgment. This is
16 on pages 8 and 9. It seems like every other person who
17 speaks says, "And it all comes back to professional
18 judgment." So if we don't get this right, you know, that's
19 an issue for a lot of other things.

20 MR. COOK: And, Bob, thanks to the group for the
21 comments about restatements. I think we heard you loud and
22 clear on a couple of items we need to do more work on, for
23 sure.

24 I should mention also - Kristen is here - that
25 the Treasury study that is being done will have a very

1 comprehensive analysis of restatements covering an extended
2 period of time, with great analysis of reasons why and market
3 reaction, and we will monitor closely that restatement study,
4 challenge some of our own conclusions against the information
5 as it is developed. Hopefully, it will be timely for that
6 purpose. We believe it probably will be. And we will
7 appreciate that information.

8 So that is happening, and while we are working on
9 our recommendations, we will stay in touch with them, as we
10 go forward.

11 Other than that, again, we will, hopefully, bring
12 you some maybe final recommendations next time, depending on
13 how we come out on a couple of these things, for further
14 discussion.

15 The subject of the judgment framework. Again, in
16 our break-up of our priorities and our scope, this is the
17 second item. We really only began to talk about this -
18 Sharon had prepared a paper for us, which was very helpful.
19 Just a thought piece, in getting our thoughts started in this
20 area.

21 But I think it's pretty clear, even just with the
22 brief consideration that we had, that there are two things
23 that are pretty much consistent in our thinking, and maybe
24 they are almost givens that you would say, "Well, wow, that's
25 not hard to figure that out."

1 One is that having a framework for the making of
2 professional judgment is a good idea; that this is something
3 that we would all benefit from, whether you're the person
4 making the judgments, whether you're the person evaluating
5 judgments at some future time, whether you're the person who
6 made that judgment who is not too keen on being
7 second-guessed about the judgments you have made. Everybody
8 seems to feel that a framework here will be helpful to us.

9 The second sort of given is that we would have an
10 expectation that the framework that is developed and is
11 recommended by this committee - if we get to that point with
12 the full committee at a future date, and I think we probably
13 will - will be meaningful in that it will provide protection
14 against someone being second-guessed.

15 Now, what that protection might be and form that
16 might take may be beyond our ability to determine, or even to
17 specifically recommend. I mean, at the one extreme, you
18 could have a safe harbor type protection, which would provide
19 lots of very significant benefits to people who have made
20 these judgments against their being second-guessed and
21 reversed on future review.

22 Perhaps it would not reach the level of a legal
23 safe harbor or a regulatory safe harbor, but perhaps some
24 form of an understanding among the parties who are engaged in
25 this process of making and reviewing judgments about the

1 rules of the road and what those rules of the road are and,
2 if they are followed, what reactions someone might be able to
3 expect at a future time - hopefully, again, not being
4 second-guessed if they have done the right things and done
5 them in the right way.

6 And we're talking about, in the first instance,
7 management, who makes the judgments, and, in the second
8 instance, the independent auditing function that challenges
9 and accepts or does not accept the judgments which management
10 has made.

11 And one of the questions for us is: Would the
12 framework be the same for the two? Would there be
13 differences between the two? What should those differences
14 be? How should they be set forth?

15 And there are different responsibilities, so I
16 think it would drive you to, probably, a logical conclusion
17 that the frameworks would have similarities, but it's
18 different from the person making a decision and someone else
19 forming an opinion on a decision that someone else is
20 responsible for making.

21 So these are kind of the things that we are trying
22 to achieve. I think what we are thinking about here is
23 consistent with the referrals that we have from two of the
24 other committees. But we will talk to the other
25 subcommittees or, at least, the chairmen of the other

1 subcommittees and be sure that where we are going is going to
2 be productive, in terms of what they think we need to be
3 doing and be sure that we don't come up with something that
4 leaves a gap between our work and the work of the other
5 subcommittees, as they are looking to us to carry it out.

6 That's the easier part. The more difficult and
7 challenging part of this will be two things.

8 One is the suggestion that we define - and this
9 was in the comment letters from Canada - that we define
10 professional judgment, so that people, at least, are on the
11 same page as to what it is that we mean. And we could
12 probably find pretty good definitions of the word "judgment"
13 and the word "professional," and we could probably add them
14 together.

15 But the suggestion here is that we think about this
16 in a fresh way, as our colleagues have done in defining
17 complexity - which I thought was very helpful and useful in
18 getting our thinking going there, and that we do the same
19 thing here in the area of professional judgment.

20 But beyond that, once we put the words around what
21 we mean - and we probably won't have great difficulty doing
22 that. We'll spend a long time at it, but we won't have great
23 difficulty. The real challenge, of course, is going to be
24 the frame of reference, the standard against which we believe
25 professional judgment should be made.

1 And I can only tell you at this point we have
2 eliminated two possibilities at the extremes. We have
3 eliminated perfection, and we have eliminated anything goes.
4 And everything between perfection and anything goes is still
5 on the table for that.

6 And we have widely disparate views among my
7 colleagues on the subcommittee and me and those who advise
8 us, and it's only because we really have not spent any
9 meaningful amount of time.

10 But when you make a judgment about the application
11 of generally accepted accounting principles, what is the
12 standard against which that judgment should be made?

13 Is it the highest common denominator? Is it
14 preferability? Is it transparency? Is it conformity with
15 the accounting literature? Is it - and, again, there's just
16 a whole array - conformity with economic substance of a
17 particular transaction or event?

18 What is the standard by which that judgment is
19 made? What would someone have to demonstrate that they have
20 achieved to have the benefit of whatever protections would
21 come around that professional judgment?

22 There are other elements in here that we talk
23 about, which we think, again, are - I wouldn't say they are
24 given, but they are generally agreed upon, which is that the
25 judgment process has to be timely.

1 It's not okay to go back and whip up a great
2 judgment process after somebody has challenged something that
3 was done three months before. It needs to be done at the
4 time that people make judgments, and statements get filed,
5 and opinions get expressed, and so on. And we believe that
6 there should be some element of documentation here, so
7 someone who is going to examine a judgment can see the
8 process that has been undertaken and the basis for the
9 conclusions that were reached contemporaneously, at the time
10 that those judgments were, in fact, made. We don't see that
11 as being as controversial.

12 But this standard - and all we have done so far is
13 just to ask questions. And we certainly welcome input. And
14 we have - we might individually have an opinion about which
15 one of those is the appropriate standard, but I don't think
16 any of us want to express an individual opinion, other than
17 to say to the full committee: Give us some help here. What
18 do you think?

19 If you had to justify a professional judgment, what
20 standard should you be able to demonstrate that you met -
21 documented on a timely basis that you met?

22 MR. POZEN: I refer people to the questions at the
23 bottom of 8 and page 9 because I think they tee up the issue
24 very well. As Mike has said, I think there is broad
25 consensus that there should be documentation contemporaneous

1 and some form of disclosure. But the question of the
2 accounting standard, since it is so crucial to the other
3 subcommittees, we would like input.

4 David?

5 MR. SIDWELL: I think many of us have been involved
6 in reviewing and putting together sections of the EITF. And
7 I think that many of the aspects here, where you talk about
8 what are the alternatives that are considered - I think
9 those are all things which often get framed as alternative A
10 and B. So while I think the documentation standard is kind of
11 important, what we want to have is consideration of the
12 alternatives and how you draw your conclusion.

13 I think it's going be very hard to have really
14 crisp lines about the other aspects of that. But I do think
15 there has to be, at a minimum, choosing around reviewing
16 alternatives and considering those alternatives in a reasoned
17 way. And you end up with a conclusion, which is documented at
18 the time that you entered into - you're always going to have
19 the issue that there is something that wasn't material, and
20 so it wasn't documented and, with the passage of time, it
21 comes to the forefront.

22 But I think, on those things that have been
23 identified as being material, I think there is a minimum
24 standard that there be some evidence of how we consider
25 accounting and disclosure matters today that I think need to

1 be drawn out.

2 MR. POZEN: Any other comments? Denny and then
3 Bob.

4 MR. BERESFORD: Just to agree with David's comment,
5 I think that most of the challenges to these kinds of things
6 after the fact are, "Well, why didn't you take position C
7 instead of position A?" I think that, in practice, companies
8 are inclined to simply develop a position for whatever they
9 want to do, as opposed to ruling out the other reasonable
10 alternatives. So I think that that is a very important part
11 of the process.

12 MR. POZEN: Well, I think we have a consensus that
13 we should look at the broad range of alternatives at the
14 time, document it, and have a reasonable explanation.

15 Bob?

16 MR. HERZ: I think, though, what Mike said is to -
17 you know, what is the guidepost? Is it just acceptable? Is
18 it preferable? Is it the best? There's still a question on
19 the -

20 MR. POZEN: Or reasonable.

21 MR. HERZ: That's on the one hand. On the other
22 hand, there is an issue of, you know, literal application of
23 some rule in our literature - because we still have a lot of
24 them; no matter what we do, they're not going to go away
25 tomorrow - does it give you an answer that makes sense?

1 Of course, the folks in other parts of the world -
2 I'm not going to make a judgment on this - they would say
3 both the preparer and the auditor should be able to, in
4 limited circumstances, you know, have what they call a true
5 and fair override in those circumstances.

6 Now, we have had it in the U.S. for auditors in the
7 Section 203 opinion, but it never gets used because you kind
8 of stand out like a black sheep kind of thing. But that
9 might be worthy of consideration also.

10 MR. POZEN: I'm not sure we are quite talking about
11 situations in which you have to have an override. We are
12 probably talking more about situations where there are a
13 number of possible alternatives.

14 So your point is well taken, but it's sort of
15 somewhat - it's a sub-set.

16 MR. HERZ: It's the other side of the coin, but it
17 does arise in practice.

18 Mr. POZEN: Yes. Joe?

19 MR. GRUNDFEST: I'm a little bit skeptical about
20 where all of this - as a practical matter, all of these
21 questions about judgments are made in the shadow of the
22 litigation system. And we have a litigation system that
23 already has in it words like "due diligence," and
24 "reasonable," and "scienter." And there are books - shelves
25 and shelves of books that go about defining many of these

1 terms, generally by example.

2 And whatever it is that me or anybody else says, in
3 terms of what we think professional judgment is, unless we
4 can cause a lot of precedent to be reversed, I don't know
5 that it is actually going to change behavior.

6 MR. POZEN: I don't know, Joe. I think one thing
7 is we have now a PCAOB inspection process.

8 MR. GRUNDFEST: Yes.

9 MR. POZEN: So one very practical thing which we
10 can influence is when people get inspected by Mark's people,
11 what should the auditors expect? AS5 is filled with
12 judgments - judgments all over the place.

13 And so that would be the first question, is: How
14 should auditors expect themselves to be evaluated by the
15 PCAOB inspectors?

16 Then the second thing is, to the extent that this
17 sort of standard were adopted by the PCAOB, and to the extent
18 by the SEC, it obviously isn't binding on the courts but it
19 seems like it might have a significant influence.

20 So I guess I wouldn't be quite as pessimistic.

21 MR. GRUNDFEST: Let me take it in sequence.

22 First, with regard to standards of reasonableness
23 as being applied by the PCAOB - again, I'm just going to
24 make a predictive observation, and the PCAOB can respond, if
25 they would like. - I would be surprised, dare I say shocked,

1 if any standard of reasonableness that the PCAOB adopts is
2 looser than a standard from which you would find traditional
3 precedent with regard to what you expect from auditors.

4 So, in other words, to the extent that there is
5 going to be additional work by PCAOB, it will either adopt
6 existing legal standards - I'm making this observation as a
7 predictive matter - or try to do something precautionary
8 around that and be even more aggressive than the current
9 legal standards.

10 And I make that observation not criticizing the
11 incentives of the people involved, but simply observing this
12 is the way the regulatory process works. I would be very
13 surprised if it goes the other way.

14 MR. POZEN: Why don't we let Mark respond. Then we
15 have Peter and Jeff.

16 MR. OLSON: I'm somewhat disappointed to say it,
17 but I almost agree with Joe on that, having given him -

18 MR. GRUNDFEST: My wife would be even more
19 disappointed than you.

20 MR. OLSON: Judgment is a very difficult thing for
21 us - for anybody, I think, that is going out and doing any
22 manner of inspection or evaluation. But it's a critical part
23 of the process. And so you have a couple of factors working
24 for you.

25 Number one, you have a clear sense of what you are

1 doing when you are going out. Remember, we're not making
2 accounting policy. We are looking at the manner in which the
3 audit process is consistent with the audit standard.

4 And so, when you go in with that very specific and
5 that very directed focus, then we are looking at the audit
6 process from the get-go, from the start, from the first time
7 that the audit process was designed, and then discussed, and
8 then, in a strategic way, implemented on the site.

9 And so the whole process leads you, then, to a
10 determination as to the extent to which judgment was used is
11 consistent with auditing standards. And so I have confidence
12 in our ability to make those judgments.

13 And then, in the process of doing so, of course, an
14 important part of the process is the dialogue that it
15 generates both on-site - and, increasingly, what we find
16 with the firms, themselves, is that there are representatives
17 from the national office that are involved when those
18 dialogues take place.

19 So I think, cumulatively, we do a pretty good job
20 of defining the parameters of judgment in these instances.
21 But it doesn't - I can't say that it's either an easy or a
22 perfect process.

23 MR. POZEN: Well, let me just - you used the word
24 "consistent." That's a word that we hadn't had in the
25 questions, but it's an interesting word, because I think what

1 we are looking at precisely is: Where there are two or
2 three, let's say, possible alternative accountings, and you
3 have encouraged the auditor to exercise judgment, and the
4 auditor does something that is, quote/unquote, "consistent"
5 with accounting standards, but it may not be the best, it may
6 not be the worst, is that the standard that is being used? I
7 mean, that would give us something to work on.

8 MR. OLSON: I would almost to have a specific
9 example of how that was done. But the benchmark is the audit
10 standard and the extent to which the audit standard was being
11 followed.

12 What is often the case is that we find - where we
13 will tend to find, for example, a GAAP departure is where
14 that audit standard was not followed, or was ignored, or was
15 not followed to a great extent. And to the extent judgment
16 has been relied on, we would ask for the source of that
17 judgment.

18 And so what is consistent is the manner in which we
19 will pursue the manner in which they came up with their
20 conclusion. Hopefully, over time, we have developed that in
21 a very consistent way.

22 MR. POZEN: But I think what is being asked here -
23 and I'm not extending this just to be a nudge - is, when
24 there are multiple approaches that could, you know, be taken,
25 and the auditor takes one versus the other - this is what I

1 think is the key to second-guessing, and there is no one
2 right answer.

3 MR. OLSON: We have talked about that extensively
4 in the transition from AS2 to AS5. We acknowledge that one
5 of our most significant challenges, is how to take into
6 consideration that element of judgment.

7 MR. POZEN: Peter, and then Jeff.

8 MR. WALLISON: Once again, I have to agree with
9 Joe. The system is driven by litigation, and the PCAOB will
10 not be helpful to auditors in establishing a standard unless
11 the PCAOB is willing to go into court and say on behalf of
12 auditor, "They did a job that we consider satisfactory."

13 I don't think they will do that. But if they were
14 willing to do that, that would make a lot of difference.

15 Now, given the fact that they are probably
16 unwilling to do that, as most regulatory agencies will not
17 do, there is one issue that I would like to raise for the
18 subcommittee, and that is the question of the audit opinion.

19 The audit opinion is misleading to most normal
20 people who sit on juries. They believe that, when you say
21 that the company's financial statements are a fair
22 presentation of a company's financial position and the
23 results of its operations for the year, or the period then
24 ended - they think that means they are accurate.
25 And, in fact, as most accountants know, that isn't

1 what it is at all. It's an estimate. Almost every important
2 thing in a financial statement is an estimate.

3 And, as a result, the accountants are put in this
4 very difficult position of telling what the public
5 understands to be - having made a statement to the public
6 that these financial statements are correct, whereas the
7 accountant knows perfectly well that they are relying on a
8 whole lot of judgments by management that they can't
9 second-guess at all.

10 And so the way to address this problem and the
11 whole question of standards, it seems to me, is to do what
12 the American Assembly suggested several years ago, when they
13 had a conference of accountants, and users, and so forth, and
14 that was to change the audit opinion, so that the opinion
15 really only says something correct when they are talking
16 about something that you could really get your hand on. And
17 that would be something like, for example, cash. You might
18 be able to verify the amount of cash that is available.

19 But when you get to all the other things in a
20 financial statement, you say something like, "These are
21 estimates of management, but we have no reason to believe
22 that these things are incorrect."

23 But the point is that we are now forcing
24 accountants into a very difficult legal position in the
25 litigation context. It would be completely different if we

1 didn't have private class action litigation; if the
2 accountants only had to report to the PCAOB or the SEC. But
3 since they have to report to courts and judges and juries,
4 they are forced into a position where they have to make
5 statements that they know to be subject to great question.

6 And so we ought to change that statement, and we
7 will then change the liability of accountants.

8 MR. COOK: Bob, let me ask if we could -

9 MR. POZEN: Yes.

10 MR. COOK: We are answering this question, or we
11 are addressing this question, as we will also, from the
12 perspective of a framework for auditors. I think we need to
13 come back - and you might get the same answers, but what we
14 are looking for here is the framework for judgments that are
15 made. And the first judgment that is made is not by the
16 auditor, but by the registrant.

17 And so leave out for just a moment - you might get
18 the same answers, but leave out the notion about PCAOB,
19 because they don't examine the registrants, and the legal
20 liability system does apply to registrants, obviously, as
21 well as auditors. But let's not -

22 MR. POZEN: We have to deal with both. But I think
23 Peter makes an interesting -

24 MR. COOK: It's a good point, on that point. But -

25 MR. POZEN: But we do have to deal with both.

1 MR. COOK: -- try to frame your response as it
2 relates to the judgment process by the registrant. You might
3 get exactly the same answers.

4 MR. POZEN: We have Jeff, Linda, Scott, and Joe -
5 since I don't want to cause anyone to go after Joe. It's too
6 hard.

7 MR. DIERMIER: Obviously this is a critical
8 element, moving towards a more principles-based system. We
9 saw in one of the earlier reports the skepticism that we
10 cannot make this cultural shift.

11 And I would just suggest (a) there are other parts
12 of the world where they are actually trying to use
13 principle-based systems and, by definition, they are
14 addressing this issue of professional judgment. So the
15 committee may want to get some of those folks to explain how
16 they claim - I know the execution and the claim may be
17 different.

18 The other thing is "documentation," is not a bad
19 word, but in listening to Mark talk, there was a lot of
20 process there. A good example of a process is that, in my
21 firm, if I make decisions by myself, as opposed to working
22 through my management committee, in one case, you may think
23 that it was professional judgment and, in the other, an
24 arbitrary decision by one autocrat.

25 MR. POZEN: I think that has been a study by

1 Professor Howell Jackson at Harvard Law School, where he
2 looked at different jurisdictions and how they go about
3 enforcing these things. So he has volunteered to come before
4 your subcommittee if you would like.

5 Linda?

6 MS. GRIGGS: I just wanted to mention the standard.
7 We did talk about whether a highest common denominator or a
8 preferable answer needed to be the one that we backed up that
9 judgment with.

10 I, for one, have a little trouble articulating
11 highest common denominator when I don't know whether - I
12 think, in many cases, there isn't a highest common
13 denominator. I'm not even sure what that means. And I think
14 there has to be a good analysis of the alternatives.

15 And, you know, maybe the EITF's framework is a good
16 one for us to look at. I don't know if they look at a
17 highest common denominator. I don't remember that
18 articulated in any of the issue summaries that the EITF looks
19 at. But I'm reluctant to go with that kind of standard.

20 MR. POZEN: I tend to agree with you that highest
21 common denominator or most transparent is a - that is an
22 invitation to litigation.

23 Scott?

24 MR. EVANS: Just sitting here listening to this -
25 I'm not an expert in these matters, but it seems to me that a

1 lot of this question of judgment and reasonableness and legal
2 precedent is well-trod stuff.

3 We have the PCAOB. We have the laws. There's -
4 it's all a question of the confidence of the participants in
5 the system and how that judgment is being exercised and
6 whether the audit firms, for instance, are acting truly in an
7 objective and independent manner.

8 And the question isn't: Can we define judgment?
9 The question is: Can we work together to move back in the
10 direction of confidence in the system, so that we can have
11 the confidence in the auditors, have the confidence in the
12 preparers to give them a break and not to be highly specific
13 in how we interpret the laws, how we interpret judgment.

14 It just seems to me that we're not getting to the
15 source of the problem here by focusing on definitions.

16 MR. POZEN: Joe?

17 MR. GRUNDFEST: If we're going to make any progress
18 in this area, what we do is - what we have to do, I think,
19 is support the proposition that it's okay to make a mistake
20 under certain circumstances. And somebody is going to have
21 to belly up to the bar and say that. All right?

22 When you talk about professional judgment in the
23 legal context - I'm a lawyer. I exercise my professional
24 judgment in a criminal trial as to whether I'm going to put
25 my defendant on the stand or not. I may be wrong after the

1 fact, and if the jury convicts my client, we may all say,
2 "Geez, we should have put him on the stand." But it was our
3 professional judgment. Or if we put the client on the stand,
4 and he or she winds up lying, it makes a bad situation worse.
5 All right? Exercise of professional judgment. In hindsight,
6 we should have done it different, but exercise of
7 professional judgment.

8 Medical care, same thing. A patient walks in, you
9 give him a pill. Son of a gun, it was the wrong pill. All
10 right? We should have given him a different pill or done a
11 different procedure, or what have you. All right?
12 Professional judgment.

13 Now, I would love for this subcommittee to tell me
14 in an accounting environment, "Hey, we came in. We gave it
15 this accounting treatment, you know." It turns out it wasn't
16 the best accounting agreement. It turns out it wasn't the
17 right accounting treatment. It turns out - you can even
18 call it a mistake in hindsight. But it was a professional
19 judgment.

20 The essence of professional judgment is being able
21 to say it's okay to be wrong under these circumstances. It's
22 okay to make a mistake under these circumstances. It's okay
23 to recognize that, in hindsight, we would have done it
24 differently.

25 And I don't hear anybody going after the problem

1 that way, because, until you go after it that way, I'm not
2 really sure what you are accomplishing.

3 MR. POZEN: Well, I can see that this is a subject
4 where we will have a lot to debate in the future, and I think
5 everyone recognizes the importance of this. I'm going to let
6 Mark have the last word here before lunch, so that will give
7 him a chance to finalize whatever thoughts he has at this
8 point.

9 MR. OLSON: An analogy that we have used when we
10 have talked about the transition from an AS2 to an AS5
11 environment is that there are, essentially, goal posts, so
12 that there is a range of acceptable answers - which is
13 different from saying mistakes are okay. I have a hard time
14 envisioning us saying that mistakes are okay. But there can
15 be a range of -

16 MR. GRUNDFEST: That's the problem. Okay? See,
17 because what you're -

18 MR. POZEN: Joe, let him finish.

19 MR. GRUNDFEST: Okay.

20 MR. OLSON: Mistakes aren't okay, Joe. But that's
21 different from saying that there is a range of acceptable
22 answers. When we have looked at the manner in which the
23 auditing firm has looked and the extent to which they have
24 followed the appropriate audit standards to come to that
25 conclusion, in the process, what we would do is the inspector

1 on-site would be in consultation with the people - with
2 their superiors within that office or on that project.

3 We would bring it back to Washington in some cases
4 -- in many, many cases, and have some other people take a
5 look at it, and we will say, "Is this within an acceptable
6 range?" And if it is, then we are comfortable that the
7 appropriate judgment has been made.

8 MR. POZEN: So you're not saying that mistakes are
9 per se right or wrong. You're saying it all depends on what
10 was the range of things and whether it was in that range.

11 MR. OLSON: That would be a better way. That's an
12 improvement over Joe's take.

13 MR. POZEN: Russ?

14 MR. GOLDEN: The only point I wanted to make is
15 what I think this professional judgment is about is not
16 necessarily that it's okay to make a mistake, but it's okay
17 to be different; that the standards are not designed so that
18 everyone will have the exact same answer, but, yet, we go to
19 great lengths in this profession so that everyone will have
20 the exact same answer. And I think what professional
21 judgment is about is it's okay to be different.

22 MR. POZEN: Well, I think we have had a lot of good
23 discussion. I'm not sure the subcommittee has the bright
24 line clear guidance on this, but they clearly have the
25 benefit of a lot of vigorous thought.

1 MR. GRUNDFEST: Mr. Chairman, we're no worse off
2 than we were when we came in.

3 MR. POZEN: Thank you. I think we're going to take
4 a break and have lunch. I'm going to ask everyone to be back
5 here at 1:40. Would that be okay, Jim?

6 MR. KROEKER: That's fine. Lunch is in Room 6000,
7 except for Subcommittee II, who is in 4000.

8 MR. POZEN: Okay. So we will aim to be back at
9 1:40. And then we will have Subcommittee IV, and then a
10 chance to wrap up. Thank you.

11 (A lunch break was taken from 1:00 p.m. until 1:45
12 p.m.)

13 A F T E R N O O N S E S S I O N

14 MR. POZEN: I think we are ready to get started
15 again. Everybody is in their positions and ready to go.

16 So we are now up to Subcommittee IV, and Jeff is
17 going to lead off.

18 MR. DIERMIER: Thank you, Bob. And a special
19 thanks, Amy and Holly. I thanked Holly before, and Amy, but
20 Amy wasn't in the room when we thanked her, so I want to make
21 sure that everybody understands the good work that both of
22 them have done for this subcommittee.

23 Bill and Chris couldn't be with us today,
24 unfortunately, so Peter and myself are going to carry this
25 discussion. I'll first cover the scope of the work plan and

1 talk about use of summary reports - we'll do each of these
2 in succession - and then Peter and I will split up the use
3 of interactive disclosure, often called XBRL.

4 A little background on the scope. We approached it
5 from the view that we discussed at the first meeting of this
6 group, and that is that financial reports were for the
7 benefit of the investor, subject to reasonable cost to the
8 corporate entity.

9 So the key initial question that we tried to think
10 about is: Well, what investors are we talking about? What
11 investors are these financial or performance reports for?
12 Because I think many of us have made comments about the fact
13 that, you know, different investors have different needs,
14 different uses.

15 And so we considered the two obvious splits - the
16 split between the retail investor and the investment
17 professional.

18 On the retail side, we decided that what we should
19 do is focus on what we called the serious retail investor.
20 This is somebody who may have a concentrated holding because
21 of a family situation, legacy situation, maybe because they
22 spent many years working at a particular company. Or it
23 could be a person who just likes to dig into the investment
24 area and, really, is very interested and wants to participate
25 in our capital markets.

1 Not so much we decided to focus on the casual
2 retail investor, partly in light of the fact that I think all
3 of us - and we're not the only country who suffers from this
4 problem or predicament - but the level of investor education
5 in our country is woefully low for the typical investor. The
6 casual retail investor might benefit from some of the things
7 that we are putting forth, but I think all of us really know
8 that that person really needs to rely on a trustworthy - a
9 really trustworthy investment advisor, and they really
10 shouldn't be a doctor who tries to operate on themselves.

11 On the investment professional side, they do come
12 in many types and flavors. We looked at segmenting the
13 investment professional, and our thought was that, basically,
14 the reporting needs for them to be of value need to be
15 focused on a fundamental investor. It could be a traditional
16 investor, it could be a hedge fund investor, it could be
17 somebody doing M&A - but somebody who would actually
18 do a detailed model of the company, in terms of their
19 prospects looking forward, so it really gets into the
20 financials, prospectively, will try to forecast out, and many
21 of these people will roll the three financial statements,
22 fully integrate it into the future, to try to get a sense of
23 the economic exposures and the economic merits of the
24 company, as well.

25 Now, even though those that do that may actually be

1 in a minority of the investment professional industry -
2 because there are so many types of people that work in that
3 field - we believe that these people, basically, are the
4 foundation of the capital markets.

5 And if our financial statements don't deliver value
6 for those model builders, then, basically, we have really
7 missed a whole lot of the point.

8 I also want to point out, in light of the initial
9 comments from the first meeting, and that is that these
10 reports are very important. A survey that we did at CFA
11 Institute contradicts the notion that nobody looks at the
12 10-Q. In fact, in a survey that we did, on a scale of 1 to 5
13 -- 5 being high - the 10-K rated out as a 4.6, the 10-Q at a
14 4.1, the quarterly release at a 3.9, the prospectus at 3.5,
15 the 8-K at 3.5, the proxy at 3.1, and the fact books at 3.1.

16 So despite the fact that on a day-to-day basis, of
17 course, you may not hear investment professionals talk a lot
18 about the 10-Q and the 10-K, at the end of the day, they
19 really look at these financial documents as the underpinning
20 of the work which they may do.

21 The scope of the paper lays out, basically, in five
22 areas.

23 Delivering financial information. Now, here is
24 something that you may take issue with us, you know, but we
25 decided to focus more on the Exchange Act of 1934 and ongoing

1 disclosures - 10-K, Q, 8-K, and things like that - and not
2 focus so much on the Securities Act. Two reasons were given
3 on the bottom of the first page there. So not focus on the
4 prospectus and new issues. So that's something you may want
5 to give us comment on.

6 We talk about the use of summary reports, with the
7 key communications through which technology may allow in some
8 form of tiering; XBRL tagging; press releases; web site
9 disclosures; and then KPIs and enhanced business reporting.

10 So the first question to the committee, basically,
11 is whether they agree with the scope, or whether there are
12 areas that we should be adding and removing from the scope.

13 MR. POZEN: Anyone want to comment on that? Susan?

14 MS. BIES: I just had a question, really, for
15 clarification. When you talk about the summary report
16 information, does this include disclosure information in some
17 way?

18 The reason I'm going there is, as we think about
19 our committee on complexity and the whole issue, especially
20 around fair value, where we are trying to provide
21 forward-looking information, which we think is what users
22 want, as opposed to the moment-in-time mark-to-market - for
23 purposes of your committee, would you have any of that risk
24 kind of disclosure included? Or is it just balance sheet,
25 income statement, today's footnotes? What do you mean by

1 financial statements?

2 MR. DIERMIER: Well, within the scope of what we're
3 talking about, yes, of course, we would include a broad array
4 of things - the whole panoply of financial reporting,
5 really. And performance reportings would be on financials.
6 Thank you.

7 MR. POZEN: Linda?

8 MS. GRIGGS: I would just say I do agree with the
9 scope. I think that it isn't important to look at the
10 offering process because I think there is a mechanism in
11 place in the offering process for issuers to provide almost
12 any information they want to when they do an offering of
13 securities. So I do think that way of limiting it is a good
14 way.

15 MR. POZEN: Ed?

16 MR. MCCLAMMY: One other thing on the scope -
17 which I agree with overall - is what you have called the
18 serious retail investors. I guess I would question kind of
19 before we head in that direction of adding too much for
20 those, what population are we talking about? I mean, if it
21 makes a difference, is that 10 percent of the investors, or
22 is a tenth of 1 percent of the investors?

23 MR. DIERMIER: Oh, I think we should just presume
24 that it's a - in the future, it could be a broad body of
25 individuals, but I think, in terms of just thinking about

1 what - you know, the kind of work that we might be targeting
2 or delivering, obviously, trying to deliver information to
3 folks that, really, only take a casual interest is somewhat
4 limiting.

5 And if you need some kind of a construct to think
6 about, think about those folks that really do have
7 concentrated holdings, large holdings, or people that really
8 will spend some time and be willing to even read a summary
9 report. But we do not know the percentages.

10 MR. POZEN: Scott?

11 MR. EVANS: So is it fair to say, Jeff, that a
12 serious retail investor is someone who doesn't necessarily
13 have any training, but wants to sit down with the financial
14 reports and understand them?

15 MR. DIERMIER: That's exactly right.

16 MR. EVANS: And whether there is a small number of
17 those people or a large number, we have an obligation, as a
18 system, to provide them with basic information.

19 MR. DIERMIER: Very well put.

20 MR. POZEN: Well, maybe we can move on. Are you
21 going to do the summary reports next?

22 MR. DIERMIER: Yes.

23 MR. POZEN: Okay. We can do that.

24 MR. DIERMIER: If you take a look at page 5, the
25 underlying principle is that, if we can increase the

1 usefulness and simplicity of company reports to individual
2 shareholders, we would like to do that without raising cost
3 or legal exposure. And, of course, even these summary
4 reports would be valuable to investment professionals, as
5 well.

6 The hypothesis is that the SEC should confirm the
7 ability of the reporting companies to provide summaries of
8 their periodic and current Exchange Act reports and other
9 outgoing releases.

10 Such reports should be able to reference the filed,
11 the furnished, or other reports on which the summary is based
12 and provide hyperlinks of such information without affecting
13 the company's liability under federal laws, and summaries
14 should be evaluated in light of the referenced documents. And
15 further, such proxy should not be considered solicitations
16 under the proxy rules.

17 Now, we talked a lot and explored the use and
18 talked about the whole notion of use of a management letter
19 -- you know, which, of course, is a bit like the annual
20 shareholders letter. But we took it to the point of saying,
21 well, not only would this letter need to be put forth on an
22 annual basis, but the company should be able to attach such a
23 letter and provide a summary along with - as a summarization
24 of other reports.

25 So like the 10-Q, on a quarterly basis, they could

1 do the annual, and there could be other things. But to
2 provide management with an opportunity where they can talk to
3 investors in plain language to understand the business and
4 its fundamental drivers.

5 We would like to give management the freedom to
6 provide summaries they believe are important for the serious
7 retail investor.

8 Of course, we talked about the Berkshire Hathaway
9 model and wondered why isn't that particular model repeated
10 more often, in terms of an annual basis or also on a
11 quarterly basis.

12 We also cited a CFA Institute survey with over 1400
13 respondents. When asked if companies should be allowed to
14 provide summary information under a more limited liability
15 standard to encourage management to open up on the
16 fundamental drivers - only 27 percent said no. Fifty-one
17 percent said yes, that would help to reduce complexity.
18 Thirty percent said yes, to encourage more press release
19 type information. So, literally, 81 percent said,
20 "Please allow more communication, and don't put
21 the communicators on the hook for legal
22 liability."

23 The benefits to the retail investor, of course,
24 would be a more efficient way to provide a concise view of a

1 company, its business and financial condition. And to the
2 more sophisticated investor, this would be helpful in
3 presenting, basically, the company and understanding the
4 company's unique story.

5 In both cases, we would expect and would like to
6 see hyperlinks, where an individual could drive down into the
7 primary document. Possibly, a warning would have to be added
8 -- I don't know - that investing based on summaries could
9 put you at a disadvantage to those that will do a more
10 detailed analysis.

11 In terms of legal treatment, we spent a good deal
12 of time on the legal treatment. In fact, we spent so much
13 time on this, that it was almost prima facie evidence that
14 some clarification or confirmation of the legal aspects of
15 this should be considered for all the companies. I don't
16 know that I fully understand it yet, but we certainly spent a
17 lot of time trying to train myself and the others about this.

18 So we discussed concepts such as incorporation by
19 reference, use of hyperlinks in a filed versus furnished
20 document, and strict liability.

21 We do not want to increase liability beyond the
22 standard anti-fraud provisions in the federal securities
23 laws, and we do not want legal staffs of companies to,
24 basically, discourage companies from issuing summaries.
25 The reason that they might do that, of course, is

1 they might be concerned that the summary might reference some
2 filed report, thereby making it filed; that the hyperlinks to
3 other materials somehow may make a connectedness there; that
4 it might be considered a proxy solicitation, unless one is
5 very careful.

6 We also want to allow them to provide the summary
7 at the same time that they might provide some other filed
8 document. We do not want there necessarily to be an
9 assumption that, because something is put out simultaneously
10 with a filed document, that it suffers the same legal
11 element, as well.

12 We also thought, to allow accessibility, that,
13 basically, these summaries should be available on a web site
14 without being considered filed or furnished. ICI, for what
15 it's worth, shows that 92 percent of its fund investors have
16 Internet access, so, obviously, that would work pretty well.

17 So why would we be so concerned about these things?
18 Currently, companies providing summaries of their glossies -
19 which there are not many - are doing so in reliance of two
20 SEC no action letters issued in 1986. So having the
21 Commission itself confirm that such summaries may be okay may
22 increase the use of them.

23 Companies may have concern over areas of omission
24 in summaries. Of course, if the documents themselves - the
25 summaries - were evaluated in light of the larger document

1 that they summarize, the error of omission in the summary
2 itself would be lessened.

3 There is also a lack of credibility, or maybe it's
4 memory, about the legal liability attached to
5 electronically-delivered information,
6 electronically-referenced information, information issued at
7 the same time, and what is interpreted as a proxy
8 solicitation.

9 So, basically, if we now could have a discussion
10 about the preliminary hypotheses in the paper, I would much
11 appreciate it.

12 MR. POZEN: Well, that's an excellent summary.

13 John, do you want to address whether you think we
14 can get to where we want legally? I think what we're trying
15 to do is to have these summaries have 10b-5 liability and let
16 them be hyperlinked and referenced to all these different
17 filed documents. Do you think that's a realistic goal for
18 us?

19 MR. WHITE: Yes.

20 MR. POZEN: Okay. Succinct, but positive. Well,
21 I'd like to get people's reaction. Denny?

22 MR. BERESFORD: This is a little off point. I do
23 support the summary reporting, but since it doesn't fit
24 anywhere else, I'd like to make a comment.

25 I think it was Linda who made the point before

1 about an awful lot of duplication between footnotes and MD&A
2 -- for that matter, other parts of the SEC reports. And I
3 think that the readability of 10-Ks and 10-Qs could be
4 improved substantially if we eliminated a lot of those
5 duplications and triplications and were able to do more
6 cross-referencing.

7 There seems to be a lot of uncertainty today about
8 what is required and what legal issues there are, and so
9 forth, and I think this is something we could probably fix
10 pretty easily. And I think it really would improve the SEC
11 filings.

12 MR. POZEN: Well, that's a good comment. That's
13 probably somewhere between Subcommittee II and IV, and we
14 will just have to work out who should take that up and try
15 to do something on that. We should consider adding it to
16 the scope of IV because I don't think it's actually there
17 yet.

18 MR. DIERMIER: It depends on how you look at -
19 we've got MD&A listed in terms of future work, not the other
20 items. But -

21 MR. POZEN: I see. Okay. So then we'll -

22 MR. DIERMIER: It's added. We'll have to take a
23 look.

24 MR. POZEN: -- take a look at that and become a
25 little clearer about that.

1 There is - as suggested here, we are not going
2 after the prospectus. I think that Bill Mann, who is from
3 Motley Fool - his view was, except for mutual funds, which
4 we continue to see registered - his view was that the
5 prospectus in the IPOs is not that crucial an issue for the
6 individual investor - partly because they don't get the
7 IPOs, I guess he said, but partly because the prospectus
8 tends to be confirming after the fact.

9 I think that the challenge here, though, is, even
10 if we look at the list on page 3, I'm not sure how short that
11 summary is going to be. And that's one of the things I
12 always worry about. It doesn't take much to be shorter than
13 a 10-K, but, you know, if something goes on for 10 pages, I'm
14 not sure it's really a good summary.

15 So I think the balance between what is really
16 important for a summary - especially if it's hyperlinked to
17 other things - is really, I think, an issue here. And I
18 would be a little concerned that the list could lead
19 you to a 10-page summary. I don't know exactly how long it
20 would take. But, you know, whether that's really what - I
21 mean, the earnings press release is only about three or four
22 pages. So -

23 MR. DIERMIER: Well, this might be more appropriate
24 for the annual summary, as opposed to the quarterly.

25 MR. POZEN: Yeah. For the annual, that's - yes,

1 David?

2 MR. SIDWELL: Maybe you covered this, but a few
3 years ago, a number of U.S. companies tried this. So my
4 question is: Did you look at what they did, and the issues
5 that they faced, what they did about it?

6 MR. DIERMIER: Well, we had some discussion over
7 the fact, primarily, that it didn't seem to encourage many
8 others to, in fact, follow that particular route. But we
9 didn't have anybody come and tell us why they haven't
10 followed it.

11 MR. POZEN: I'm trying to think - in the mutual
12 fund area, we've had a number of efforts in this area.
13 Several reporting companies. Is that true, Bob?

14 MR. HERZ: My recollection was that, in the 1980s,
15 there were some experiments on this, and it didn't go very
16 far.

17 But then, in the 1990s, there was a revival of the
18 idea, but it was actually - I think the SEC may have
19 actually exposed something. But it was abandoned after
20 comment from a lot of investor groups that opposed it on the
21 grounds that it would be too selective and would restrict
22 information, even though you could - I think what they
23 proposed was you'd get a summary version and you could
24 request the full. Now, this was back in mid '90s, before the
25 Internet, largely - you know, paper-based documents

1 completely, a lack of technology.

2 MR. POZEN: They thought that getting the summary
3 with, say, 800 number to get the full document was not
4 sufficient?

5 MR. HERZ: My recollection, there was broad
6 opposition from the professional investor ranks.

7 MR. POZEN: Is that from professional individual
8 investors or -

9 MR. HERZ: No, the investment industry,
10 institutional investors, all that. I'm sure the SEC can go
11 back and probably get a summary of the letters.

12 MR. POZEN: Sue?

13 MS. BIES: If I am remembering right, I think one
14 of the other issues was, for the retail investors, the firm
15 that owns those accounts does not want to disclose who the
16 owners are. So all of the shareholder information goes
17 through whoever is the custodian for those accounts.

18 And so, for the company, you didn't know who was
19 retail and who was professional. And that that was part of
20 the issue, too.

21 MR. POZEN: I see. Well, that's an important issue
22 that we hadn't, I don't think, taken into account. So we're
23 going to have to look at that. That is important.

24 The question is whether, now, the Internet makes
25 all this a lot easier, so people can --

1 MR. BERESFORD: There actually were quite a few
2 companies in the last two years, though, that have filed
3 summary reports. I think they have usually been accompanying
4 the annual reports, so if you want to read the abbreviated
5 version, you can do that.

6 But I think the subcommittee might want to look at
7 those, ask a few of those companies why they chose to do it
8 and what the pros and cons were.

9 MR. POZEN: That's a good suggestion. I guess
10 we'll ask the staff to see if they can find those examples
11 and see what happened on those.

12 Greg?

13 MR. JONAS: I also recall the surveys back in the
14 '80s, you know, when this first surfaced. I have a
15 recollection that the retail investor was also opposed to it.
16 Their rationale was, "It sounds like you're trying to give me
17 less than what the pros get."

18 I think, frankly, the way the survey was done,
19 there really was no broad support for it among any of the
20 constituencies at the time.

21 MR. POZEN: It sounds like every good deed deserves
22 a punishment. You know, somebody sort of tried to do
23 something.

24 But maybe we ought to check this out with some -
25 we are using Bill Mann from Motley Fool, but we might want to

1 check it out more broadly. We surely don't want to spend a
2 lot of time developing a document that people are going to be
3 offended by.

4 MR. JONAS: A question for Jeff, though, about the
5 notion that he raised in his very opening comments, which was
6 the notion of drill-down.

7 And, Jeff, did you guys have in mind, with this
8 notion of a shareholder letter, that that would be within the
9 notion of drill-down, or is that more add-on? And drill-down
10 would be something that would provide - you could probably
11 use the analogy that it would provide a company a short story
12 at the top level. And then any reader, including the
13 sophisticated investor, would all start with the short story,
14 and then, at their discretion, they can go deep into the
15 detail, as they deemed appropriate by drilling down.

16 MR. DIERMIER: I think that's a good intellectual
17 way to think about it. We did have a demonstration - as you
18 might imagine, with the technology that's available now
19 today, one could fairly quickly take that idea and make that
20 much more sophisticated.

21 A couple of us who actually saw the demonstration,
22 we used the term "breathtaking," in terms of the quick
23 ability to move from a summary into, you know, the next
24 topic, XBRL, into press releases, and on to other types of
25 elements.

1 So the notion that, somehow, this information could
2 be linked to other documents and other information would be
3 valuable for all investors. And that's why, in my remarks
4 and in the report, we talk about the fact that the
5 professional investor may very well like this summary quite
6 well, as well, and might use that as a starting point to do
7 their drilling down.

8 MR. POZEN: I think Greg's suggestion is quite good
9 because, if everyone started with the same document, then you
10 would eliminate the sense of, you know, somebody being a
11 second class citizen. And I hadn't understood the full angst
12 that had gone on in the past, so I think this is very much
13 worth considering. We ought to try to also touch base with
14 some other investor groups to see what their -

15 MR. DIERMIER: There are some investor associations
16 that might be -

17 MR. POZEN: Yeah, Mark Griese and some other people
18 -- so that we are on the same wavelength.

19 Mike?

20 MR. COOK: I was just going to give Jeff a point of
21 reference. That study and the work that was done in the '70s
22 or early '80s, something like that, was done by the Financial
23 Executives Institute and an accounting firm called Haskins &
24 Sells, which is - the firm is no longer in existence, but
25 FEI probably has that information.

1 They really drove that study and did the surveys,
2 and things like that. They have offered their assistance to
3 you in this project, so maybe just give them a call and see
4 what they have.

5 MR. POZEN: Great.

6 MR. COOK: I think - my recollection of it was
7 that this just never really went anywhere because the hope
8 was that there would be some substitution - if you did a
9 summary report, you wouldn't have to send everybody a 10-K.

10 But, again, those were in the days of paper, and it
11 just didn't work. So there was no cost reduction. It was
12 just incremental costs. And I think everybody just threw
13 their hands up and said, "Oh, what the heck. People aren't
14 reading the annual report, anyway. Why send them something
15 else they may not read and just spend more money?"

16 And that's what kind of took it down. But I think
17 the technology change could make this much more viable today.

18 MR. POZEN: Ed, and then Joe.

19 MR. NUSBAUM: Just a quick question. It seems to
20 me that you have - I don't want to say dismissed, but down
21 played, at least, the posting of information on the Internet.
22 It seems to me that most investors are so agile with the
23 Internet - they're using it constantly - that it would seem
24 to me that maybe they could just take something like this and
25 include it on a company's web site, if it's available, and,

1 that way, it allows the drill-down into the full 10-K.

2 Did you consider that?

3 MR. DIERMIER: We did. And, in fact, when we get
4 into the web site discussion later on, we fully intend to -
5 like I said, that breathtaking experience, that was on a web
6 site.

7 MR. POZEN: Joe?

8 MR. GRUNDFEST: Speaking of breathtaking
9 experiences, much of this would already be possible virtually
10 overnight if we changed the way EDGAR works.

11 As a practical matter, the way EDGAR is structured
12 now, when I go to the Internet, if I decide that what I want
13 to do is compare certain sections of publicly-available
14 information, I can't do that by using the Google search tool
15 or any other search tool. And that is, in part, because of
16 the way the SEC finances EDGAR. All right?

17 The raw EDGAR information is not out there sitting
18 on the Web, so that I can crawl, all right, whether I'm on
19 Google, or Microsoft, or Yahoo!, or what have you, and then
20 do the overlay. All right?

21 It's very cheap for these people to be able to
22 develop all of the stuff so they would be there free and
23 available overnight.

24 If we can simply get the documents to be - if you
25 designed EDGAR today, what you would do is you would use

1 certain technology that would certify that, "This is the
2 original document." You would simply post it to the Internet
3 in a way that the SEC would designate. It would then be
4 deemed filed. It would be available for every search engine
5 immediately to look at. You would know what the original
6 document is, and you wouldn't need anybody else to do, you
7 know, redistribution, or what have you. It would be easier,
8 simpler, cheaper, better than what we have now.

9 And the question that I would put to the Commission
10 is: How can we get there as quickly as possible? Because,
11 needless to say, there are lots of users that would love to
12 have these whiz-bang, unbelievably sexy tools available to
13 them. And I think the only think that is keeping them from
14 it is free access to the underlying data, which are publicly
15 filed with the SEC.

16 MR. POZEN: Well, I think some staff is going to
17 have to look at that issue. I just don't know enough to make
18 an intelligent response, and I don't think our subcommittee
19 has looked at it.

20 But we have Con, and then John.

21 MR. HEWITT: Yes. EDGAR is being overhauled for
22 that purpose. It's obsolete. We know that. And it will be
23 tied in with the new taxonomy's technology. I don't have a
24 -- it's being processed now, being changed now, but it's
25 going to take some time to get it all completely done. We

1 don't have a timetable on it, but it's in process.

2 MR. POZEN: John, did you want to add anything?

3 MR. WHITE: A lot of this is handled by the XBRL
4 plans, I think.

5 MR. GRUNDFEST: The XBRL, as I understand, the
6 first wave is simply the numerical data.

7 MR. WHITE: Well, it's the financial statements.

8 MR. GRUNDFEST: The financial statement, right -
9 the numerical data in the financial statement.

10 But if you wanted to build more intelligent tools
11 -- for example, I'll take the latest 10-K and do an automatic
12 compare and contrast of the risk factors with the last 10-K,
13 XBRL doesn't do that for you.

14 Do we have software that could do that immediately?
15 Yeah. But what do I need? I need the raw text for - the
16 full text of the 10-K.

17 If I want to do, you know, a word search -

18 MS. GRIGGS: You can do that now. You just -

19 MR. WHITE: But you can do that. You can download
20 anything you want. It's all in full text.

21 MR. GRUNDFEST: It's not freely available over the
22 Internet to be -

23 MS. GRIGGS: Yes, is it. It's on the SEC's web
24 site. You go on the SEC's web site, you block the disclosure
25 you want, save it to your computer, and do a comparison. We

1 do it all the time.

2 MR. GRUNDFEST: We'll have a separate conversation
3 about what can be done.

4 MR. POZEN: Maybe we ought to go offline for this.
5 Let's go offline and try to figure that one out.

6 I do think one other thing that we need to consider
7 -- and I don't know what the status is; whether this is
8 something that maybe NASD Foundation is doing - there still
9 are, obviously, pockets of people who don't have Internet
10 access who are investors.

11 I don't know, John or Con, whether - you know, I
12 know the NASD is running the foundation now - the Investor
13 Education Foundation - whether there is any effort on their
14 part, as part of that, to get training of elderly groups, or
15 minority groups, or the various other groups, in terms of the
16 Internet, and these sorts of things.

17 Because I think there is a concern. I think you
18 know that, if you have an Internet strategy, there will
19 always be people who, "Well, we're not on the Internet."

20 And how do you deal with that?

21 MR. HEWITT: Our office of investor education.
22 We're going to groups throughout the United States,
23 especially on these scams that come through - there are a
24 lot of scams that are coming through the Internet, and we're
25 trying to educate the elderly on how to avoid those and what

1 to look for.

2 MR. POZEN: But if they don't have an Internet,
3 then they don't have to worry about being scammed, right?

4 MR. HEWITT: No, they don't. They won't get
5 scammed then.

6 MR. POZEN: But, on the other hand, they're not
7 going to get Internet summaries, either. I think -

8 MR. WHITE: Bob, I think just one more point.

9 MR. POZEN: Yes.

10 MR. WHITE: Go back one step here in the
11 conversation. When we're talking about - or your
12 discussions of summary data or summary presentations, I'm
13 assuming that the basic content is derived from documents
14 that are filed in the SEC system, I guess is the first thing.

15 I guess I had not thought that liability - which
16 was one of the first questions, way back in the beginning of
17 this conversation - was really a deterrent issue here.

18 MR. POZEN: I can tell you that my experience is
19 that it is.

20 MR. WHITE: We've had this conversation other
21 times, and I know you think it is. I just had not thought
22 that that would be, like, the deterrent. I mean, if
23 companies aren't doing it -

24 MR. POZEN: I think there is a combination of a few
25 things. One is - I think Mike suggested, at some point,

1 people thought you were going to be able to reduce your costs
2 by doing this. And if it's just an add-on, people think,
3 well, it's just creating more work.

4 And then second is that - well, I'm speaking
5 heavily from the mutual fund area, where the summary
6 prospectus has been hung up by this liability issue. So I
7 think -

8 MR. WHITE: I mean, I think the bigger issue is
9 whether companies want to take the time and effort to write
10 the - what I guess I would have thought was the Warren
11 Buffet letter. Write the summary, put together in one place
12 the information that they want to convey in the summary
13 version of this - not how they get it to people, but whether
14 they want to create it, in the first place.

15 MR. POZEN: Well, I think you're probably right
16 that that is also an issue, in terms of whether people want
17 to do that.

18 But, I mean, you know, I've been in boards of
19 directors meetings where people have said they are thinking
20 of doing this, but it's extra work and then just extra
21 potential liability, so why do it.

22 I mean, they all do earnings releases, so that
23 they, you know - but that has a real function.

24 MR. WHITE: Yeah, but, I mean, many earnings
25 releases are - there's a lot of effort going into them.

1 MR. POZEN: Right.

2 MR. WHITE: And they're not exactly like you're
3 describing, but they are written to be investor-friendly
4 quite often. I mean, I guess I almost envisioned this as an
5 expanded version of the earnings release, where you might -
6 you know, you might want it to come out at the same time.
7 That's a pretty logical time for it to come out. But just go
8 and work on your earnings release to make it more useful in
9 the way you're talking about.

10 I mean, I just didn't think this was
11 liability-driven or mechanics-driven. I think I thought it
12 was much more just companies being willing to create the kind
13 of document you're talking about.

14 MS. GRIGGS: My experience is the same, John. I
15 think the clients that I have that use the summary report are
16 very, very few. Mostly, companies feel, in their annual
17 report to shareholders, they can put what they want to into
18 their chairman's letter, and they just don't think there's
19 any point in developing yet other document.

20 MR. WHITE: And, just as another piece of this,
21 with electronic proxy now in place, you can deliver all this
22 electronically. You no longer have to deliver the paper,
23 unless the individual investors specifically request it. We
24 also have - for the underlying documents, we have much
25 efficiency.

1 MR. MCCLAMMY: I think one of the biggest questions
2 will be the treatment of non-GAAP adjustments. And if you
3 have a non-GAAP adjustment in the summary schedule, do you
4 need all the reconciliations for every line item that's not
5 GAAP? And do you need the two pages that describe why that's
6 useful information, but not necessarily a position that is
7 better for GAAP?

8 Say, if you take a press release today - and
9 forget, Bob, what you said about 10 pages - there will be 10
10 pages of attachments to it.

11 MR. POZEN: Yes, Thom?

12 MR. WEATHERFORD: Well, I don't think we're talking
13 about a pass for Reg G.

14 MR. MCCLAMMY: I guess my point is that I don't
15 think we should be expecting to get a two- or three-page
16 summary. It's probably going to be a 20-page summary.

17 MR. WEATHERFORD: Yeah, I think, actually, this
18 document exists today, and it's the earnings call script. And
19 it has everything in there, from key performance indicators,
20 to summary of the business, et cetera.

21 And what happens is some companies post this and
22 others do not. By just having every company post this on
23 their web site, you solve the issue - because you're going
24 to get to the press release, in many cases, based on lawyers'
25 input to make it as minimal as possible; no marketing data in

1 there. That's the answer.

2 MR. POZEN: There are a lot of good comments here,
3 and it will probably make us re-think about whether this
4 summary, in the way that it was being contemplated, is really
5 a useful document, or whether we ought to think about an
6 expansion of the earnings release, or the transcript, or
7 something like that.

8 MR. MCCLAMMY: One other quick comment is - I
9 think it was off of something Denny said - is, you know,
10 that if you go back in time probably 10 years, what we're
11 describing is almost the 10-Q; that the 10-Q was probably a
12 10-page document. And people could end up - you'd quickly
13 get through the financials. There were key footnotes on what
14 had changed. And, you know, there was an MD&A that was easy
15 to get through.

16 So I think we have almost created the need for
17 something like this because of what we've done to the 10-Q.
18 And maybe we should try to fix that, rather than putting a
19 Band-Aid on with something else.

20 MR. WHITE: But, again, you're talking about not a
21 new requirement, right? You're talking something that is
22 optional?

23 MR. POZEN: Yes. I think we're not talking about
24 --

25 MR. WHITE: You're not requiring posting the

1 transcripts, just -

2 MR. POZEN: Well, I think Thom may have suggested
3 that, if you have a transcript, that he, at least, is
4 considering requiring posting it.

5 MR. WEATHERFORD: Yeah. My comment was: We don't
6 need an additional report. I agree with Denny that we need
7 to improve the 10-Q, or we need in look at the earnings
8 release - because everything that is needed in terms of a
9 summary report is in that document, the earnings release.
10 That's probably the most comprehensive operational report out
11 there today.

12 MS. GRIGGS: But I don't think we need to make any
13 proposal to fix the earnings release. It seems to me those
14 are within the province of the companies, and companies use
15 them both, probably pretty effectively.

16 MR. WEATHERFORD: You and I are saying the same
17 thing. Companies should have the freedom to do it, but
18 either we would have to propose a new requirement - the
19 statement is something that's very popular.

20 MR. POZEN: Maybe we need to go back to point zero
21 and think about: Do the serious retail investors need more
22 than the earnings release? That has to be the threshold
23 question. If they do, then we can think about - if they
24 need something more that's less than the 10-K, then
25 encouraging people. But it may be the case that they don't.

1 Bob?

2 MR. HERZ: I was going to make a comment kind of
3 like Thom's, because if you listen into, you know, investor
4 calls of companies, you know, when hear the stuff up front,
5 it's kind of what you are looking to here, more meaningful
6 stuff. But people don't listen in to the investor calls - I
7 guess everybody could.

8 But, to me, it's really a question of what the
9 focus of the - whatever this thing is. Whether it's a
10 summary report or it's your earnings script, it's whether or
11 not - it's kind of the Warren Buffet thing about, you know,
12 "What do I need to tell my partner? He has been away for a
13 year, or the quarter. What does he really need to know about
14 in order to judge our performance and where we're going, and
15 all that?"

16 And I think that varies an awful lot between
17 companies, as to whether they really - you know, are willing
18 to be kind of open, honest, and direct about those things
19 versus being much more kind of boiler plate and just driven
20 by, you know, "Sales were up 10 percent. I guess we had a
21 good quarter" type of thing, without it being very
22 insightful.

23 MR. POZEN: One last question before we go to XBRL.
24 Scott, did you have a comment?

25 MR. EVANS: Yeah. Just a suggestion. Jeff, you

1 might want to think about - in just listening to all this -
2 having some focus groups for the serious retail investors and
3 finding out what their eminent needs are with regard to the
4 stuff that they currently get from the SEC, or the SEC
5 required disclosures and take it from there.

6 Whether there are things that they are getting that
7 are too complex for them to process which need to be dealt
8 with in a different means of delivery or a different language
9 of delivery. Whether there are communications from companies
10 that would help them assess a company's prospects that they
11 are not getting in a form that they can use. And see how
12 that fits in with the mosaic of things that they are given.

13 MR. POZEN: Okay. Well, I think we want to leave
14 some time for XBRL, since that is a significant subject.
15 Jeff?

16 MR. DIERMIER: I'll kick it off, and then I'll turn
17 it over to Peter. I think I'll be brief. Hopefully, I'll
18 get the right tenor and tone of my early remarks.

19 The group that studied this whole concept of XBRL
20 and where it will take us, as stated on page 11 in your book,
21 in the underlying principle - we think there is significant
22 end game benefits.

23 In fact, not only that, but we had, it says in the
24 paper, unanimous agreement on the part of the committee. But
25 there was even unanimous agreement in terms of the three

1 companies that presented to us, the three users, the senior
2 representative of a corporate association - unanimous
3 opinion and agreement that where XBRL can take us could be
4 very, very valuable - and not just for investors, but for
5 academics, for quants, for transparency, in general.

6 And then when you start to think of the
7 opportunity, of the viral impacts of standards, of
8 technology, and smart people, you know, it really starts to
9 become mind-boggling.

10 So the issue a little bit more is: In the current
11 space, how do we get from here to there? Because it makes
12 sense that companies, users, software developers would not
13 want to make an investment in terms of this technology until
14 there was sufficient certainty to suggest that, in fact, it
15 is time for them to no longer do a wait-and-see, but actually
16 make those investments.

17 So the question for us altogether here is: How do
18 we create that level of certainty?

19 You see in the preliminary hypotheses that the
20 group felt so strong about the long-term benefits, that if
21 the implementation could be thoughtfully rolled out, that
22 people like Peter and myself, who almost never like mandatory
23 anything, would recommend that, actually, mandatory would be
24 an acceptable path, if, in fact, that was the only way that
25 we create sufficient certainty for the investments in

1 adoptions to, in fact, be put forward.

2 But we are very cognizant of the fact that many
3 corporate spokespeople indicated that they would need this to
4 be rolled out in phases; that they would need to learn from
5 the early phases how things are developing. They would want
6 to move as the software, basically, develops. And, even
7 then, they were supportive of mandating, which I thought was
8 very strong, as well.

9 I think I'm going to skip over the benefits to the
10 investor users because there is a long list from that
11 standpoint. The simplest form of it is you reduce the cost
12 of research. Of course, you increase the quantity and
13 quality of the research that will be done.

14 But it goes down into a lot of deep levels. You
15 can look at a lot of different ways in which users use this
16 kind of financial information. Just simple things like
17 organizations that aggregate databases taken from 10
18 different sources, where the sources just didn't come
19 together, and you make all kinds of errors in terms of
20 transposing some of the -

21 MR. POZEN: I think we can all agree that, for
22 users, this is a good thing. The question is from the
23 registrants' point of view, whether this is too burdensome or
24 not.

25 MR. DIERMIER: And some of the comments in that

1 regard are: That working group that we had at the CFA
2 Institute, they indicated some concern that, if the tags were
3 done wrong initially or inconsistently applied - they were
4 afraid that some of the users, then, would go away, and they
5 would just stick to their old ways of doing things, and it
6 would take them a while to get back. So they raised the
7 question in terms of the reliability of the information.

8 My final point on the user side should be: You
9 should not interpret the lack of wild enthusiasm and quick
10 demand on the part of users as a sign of it not having value.

11 You know, the way in which most serious model
12 builders put their models together, they have intellectual
13 capital oftentimes built into 10 or 12 companies, and it's
14 going to take a while for them to roll the analyses or those
15 models into a new framework, just like anybody who has got
16 intellectual property in development.

17 And so just like when EDGAR first arrived - many
18 of those folks thought they didn't need it and, 10 years
19 later, they couldn't live without it - there is no question
20 in my mind that the users, 10 years from now will feel they
21 couldn't live without it.

22 Let me turn it over to Peter for some of the more
23 interesting facets.

24 MR. WALLISON: Thanks very much, Jeff. Just in
25 case anyone out there doesn't know what XBRL is, first of

1 all, it's called by the SEC interactive data. So when you
2 hear the Chairman speaking in conferences about interactive
3 data, he is also talking about XBRL.

4 We decided to use the term "XBRL" in our
5 subcommittee. It's a little bit easier, even, to say than
6 "interactive data."

7 XBRL is a derivation of a very widely-used now what
8 is called eXtensible Markup Language. And the word
9 "extensible" means that you can add after a word contextual
10 data in the form of tags.

11 You might think of it this way, and that is, if you
12 want to know the reserves of all of the oil companies, if you
13 use just the word "reserves" to search, you would get other
14 kinds of reserves that are in financial statements, in
15 footnotes, and so forth. But you use "reserves.oil," it
16 would be very clear. That puts a contextual statement on
17 another word, further defining that word.

18 Now, XBRL is, really, as I described, a derivation
19 of a digital code called SXML. It really allows financial and
20 non-financial information - that is, numbers, as well as
21 narrative information - to be machine-readable. This is the
22 key point: It's machine readable.

23 In one sense, it's kind of like a dictionary.
24 Through standardization, the people who have been working on
25 XBRL over all these years have standardized it with terms

1 that are used in financial statements.

2 So to give you a simple example, some companies
3 refer to sales, some companies refer to revenue, some
4 companies refer to turnover. All of those terms generally
5 refer to the top line on the income statement. Now, they are
6 all standardized, so that, in XBRL, they are represented by
7 the same piece of code with a couple of tags on it that
8 define it a little bit further.

9 What this means is that, when someone is trying to
10 find out the sales of, let's say, all the pharma companies,
11 all you have to do is put in a search - it's a regular
12 search engine - into the SEC's files, when they are properly
13 produced in XBRL, or adjusted so that they can be read in
14 XBRL - and, incidentally, the SEC has put about \$48 million
15 into making its EDGAR files searchable this way.

16 But all you have to do is put in, say, the word
17 "sales" in the pharma category and, in seconds, all the sales
18 numbers of the pharma companies will be downloaded into your
19 spreadsheet.

20 Now, the old way of doing this, as any analyst will
21 tell you - or any investor who is serious about this stuff
22 -- is, if you want to know the sales of all of the pharma
23 companies, you have to download all their financial
24 statements, and then you have to search through them and find
25 sales and how they are adjusted, and so forth, and then plug

1 that by hand into your spreadsheet in order to have them all
2 align.

3 Well, it converts, really - and, of course, sales
4 is the simplest thing to get - but it converts, really, a
5 very time-consuming process into a process that amounts to
6 only a few seconds.

7 And it's not just things like sales, but imbedded
8 in the XBRL taxonomy is a word like "EBITDA." So if you want
9 to know the EBITDA of all the pharma companies, for example,
10 you can search by that.

11 MR. POZEN: Peter, can I just ask you - I think
12 people have read the materials -

13 MR. WALLISON: Oh, okay.

14 MR. POZEN: -- and you can just more focus on the
15 issues here.

16 MR. WALLISON: Okay. So the advantages that this
17 provides are enormous, not only to users, as Jeff was
18 suggesting, but also to the companies.

19 First of all, what it does for companies is to
20 provide them with a better way of communicating with analysts
21 and with investors. When they release their corporate data,
22 for example, it will drop immediately into the formulas, the
23 analytical structures, the models that the analysts use for
24 the purpose of analyzing the company.

25 So while you are on the phone, as a company, with

1 the analyst who you are trying to talk to and explain
2 something to them, by releasing your data, it goes
3 immediately into their models, and they can, based on their
4 models, ask much more intelligent questions about how your
5 company is operating.

6 This, of course, results in much reduced costs for
7 searching data and much reduced costs for analysts. And, as
8 a result, for smaller companies, it may produce much more
9 coverage than they have been receiving recently. As we all
10 know, many small companies are no longer receiving analyst
11 coverage, or as much as they used to, because it's very
12 expensive to cover them. And this would reduce the costs
13 very substantially.

14 So I think we can expect, under XBRL, that there
15 will be much more coverage of smaller companies.

16 Also, it improves the quality of data. Most
17 analysts and others - I won't say most, but many, many
18 analysts and others use aggregators to bring to them
19 information that has been published by companies. The
20 aggregators draw down that information, they put it into
21 their own formats, and they sell to analysts and others who
22 work on analyzing companies.

23 Well, one of the problems with that is that there
24 is an input problem. When the aggregators create their
25 particular product, sometimes they make mistakes in

1 inputting. They also have different formats that they use -
2 all of which makes it much more difficult to analyze that
3 data.

4 So the companies' advantage, again, comes from the
5 fact that, when you release your data, it doesn't go through
6 this process, and it doesn't have to be inputted. So there
7 aren't any mistakes that can be made in the inputting
8 process. And, as a result of that, companies get a much more
9 reliable set of data into the hands of the investors and
10 analysts who are looking at those numbers.

11 MS. GRIGGS: Peter, I had a question.

12 MR. WALLISON: Yes?

13 MS. GRIGGS: Your paper says that XBRL will
14 actually save money for companies. And I was just wondering
15 -- I understand how it may help the marketability of their
16 securities, but I didn't understand how actually preparing
17 financial statements by companies would be less costly with
18 XBRL.

19 MR. WALLISON: Well, there are a number of ways,
20 actually, but we can talk about one of them.

21 When companies receive the data from their
22 operations, it comes into various kinds of software within
23 the company. Say, sales would go into a certain software
24 application that they are using to record sales and to
25 calculate commissions of the salespeople, and so forth.

1 Normally, when they prepare their financial statements using
2 that data, they download it and then plug it into either a
3 Word document, or a spreadsheet, or something like that.

4 If they are using XBRL, they don't have to use a
5 person's time to do that - to add up the numbers, put it all
6 together into a package, and put it into a ledger or into
7 their -

8 MR. POZEN: It may be useful - because I think
9 Linda asked a very important question - to get some input
10 from Ed and Thom, who deal with a lot of the smaller
11 companies, as to whether you view this as a cost-saver or as
12 a burden.

13 MR. WEATHERFORD: Well, having spent five years as
14 this intelligence space was in its early stages, this is
15 something that is very close to me, in terms of data.

16 I think, any time you implement software in a
17 company, it always takes longer and costs more than you
18 originally assumed. And with XBRL, even though the intent
19 makes a lot of sense, I think to edict one way for companies
20 to analyze and to consolidate data is a major challenge. And
21 I'm not sure if companies that are smaller companies have the
22 bandwidth in which to do this.

23 MR. DIERMIER: That's why, in terms of phasing
24 things, we thought that there would have to be a small
25 company consideration phase, potentially.

1 MR. WEATHERFORD: The other thing is not knowing -
2 because if you look at sales, and let's say you are just
3 analyzing sales, the next thing you want to know is how much
4 sales are from customers, distributors, et cetera. And so
5 this thing can gather a life of its own and totally overwhelm
6 in the name of getting data to investors - totally overwhelm
7 the companies on how they collect and report data.

8 MR. POZEN: Ed, then Joe.

9 MR. MCCLAMMY: I agree with Thom's comments, but
10 also agree that interactive data is the way that we need to
11 be headed as we go forward. My concern is that we need to do
12 it in a very methodical way of transitioning there.

13 I can tell you, when I read this, 404 flashed in
14 front of my eyes, of something that everyone said out of the
15 chute, "This is going to be very easy and, you know, cost an
16 average to the companies of \$20,000 to get implemented." And
17 then, as we got into the implementation, it just turned out
18 to be tougher and tougher.

19 So you say you're trying to take small companies
20 out. Small companies were out in 404. But I think it was
21 the smaller - I'll say mid-size companies or even smaller
22 than mid-size that, in the first days of 404, really took the
23 brunt.

24 And, in fact, the type of preparers that my company
25 is, and other mid- and small-sized companies, are still

1 trying to recover from the efforts of 404 and getting back to
2 things.

3 I just think we need to be very careful, and if
4 we're going to have - we need to be careful of what that
5 initial date is and to keep it to very large, sophisticated
6 companies to be in the first wave. If you get much past the
7 Fortune 500, I think it's going to be bad, and then they will
8 have to speak for themselves. I don't think small- and
9 mid-sized companies have the bandwidth to take this on in the
10 next year or two.

11 As far as picking up additional coverage - I mean,
12 I'm a CFO. We also look at how to improve profits. I think
13 there is just as much chance that there will be fewer
14 analysts, if analysts become more efficient, because people
15 like a Morgan Stanley or more investment firms will be
16 looking at, "Can I get by with fewer assets?"

17 MR. POZEN: Ed and then Peter.

18 MR. NUSBAUM: I take a little contrarian view here,
19 but I think - I hear the concept that it has to be phased
20 in, and we shouldn't use 404, but a much longer phase-in,
21 starting with the very largest companies, but I see some
22 benefits for companies of all sizes.

23 I just think - there are going to be initial bugs.
24 There are going to be software issues. But, over time, this
25 will, I think, speed up the process of people getting

1 information out, allow better analysis of companies of all
2 sizes, allow individual investors, as well as sophisticated
3 investors, to analyze smaller and mid-sized companies.

4 I just see a huge benefit in it. In many ways,
5 it's almost like putting out footnote information. It's
6 good, reliable information that the analyst can use. I just
7 don't see that the burdens, over time, will be that great.
8 There will be some big initial burdens, but we can phase it
9 in over a longer period of time.

10 MR. POZEN: We have Peter, Joe, and Susan.

11 MR. WALLISON: I think we don't know enough now
12 about what the costs of this will be. But we have heard from
13 companies that have put it into place, that the costs are
14 remarkably small. And I don't want to make any promises
15 about this, but they have told us how simple this is to put
16 into place. So when we've done a little bit more
17 investigation, I think we will be able to see that the amount
18 of cost that companies will have to pay.

19 It is very unfair to treat this as a 404. I was
20 one of the great opponents of Sarbanes-Oxley, precisely
21 because I saw it as a huge cost being imposed for no reason
22 whatsoever, and what we have here, I think, is something that
23 will save companies a tremendous amount of money.

24 MR. POZEN: Joe and then Susan.

25 MR. GRUNDFEST: Is the taxonomy being developed in

1 XBRL also being adopted by other software providers - the
2 SAPs and the Oracles?

3 MR. WALLISON: Yes.

4 MR. GRUNDFEST: Well, that's key.

5 MR. WALLISON: What happens is - for example, with
6 Hyperion, which is used by many, many companies, it just
7 absorbs XBRL. At the point Hyperion had XBRL, it just
8 absorbs the entire taxonomy.

9 MR. GRUNDFEST: So I think that's a very important
10 point to make to committee members that are concerned about
11 costs -

12 MR. WALLISON: Right.

13 MR. GRUNDFEST: -- because you have to, as a
14 practical matter if you are a publicly-traded company, have
15 one of these large software packages. If the package already
16 integrates the XBRL, then the marginal cost of the federal
17 mandate is critical.

18 MR. WALLISON: They do. Let me address, if I can,
19 this question of fewer analysts. We don't really think that
20 will happen, but what I do think will happen is that XBRL
21 changes so much the economics of analysis and it reduces so
22 much of the cost of getting this information, that what will
23 develop is the whole business of analysts selling their
24 information and selling their analysis to the ordinary retail
25 investor, the way Motley Fool does, but many, many more of

1 them for much less cost to investors.

2 MR. POZEN: Well, I have some experience with
3 analyst coverage, and I think it's more complex than just the
4 cost of the data.

5 MR. WALLISON: Of course.

6 MR. POZEN: I mean, ultimately, you're buying the
7 judgment, and people want to cover stocks that they think
8 that they are likely to buy, et cetera. So I guess I'm not
9 sure it's going to have a big impact on analyst coverage. I
10 would say a modest impact.

11 Sue?

12 MS. BIES: Just one quick comment along the lines
13 Joe just mentioned. When the bank regulators mandatorily
14 required XBRL for all of the regulatory work, what really
15 happened to make it affordable for the small banks - as you
16 know, there's thousands of very small banks in this country
17 -- is the software industry who supports the general ledger
18 systems and other application systems basically saw this as a
19 new profit opportunity and built the underlying application
20 systems to interface.

21 And if you've got the software vendors building the
22 application systems, then it becomes just part of any routine
23 update of their core software applications systems, and the
24 costs are significantly lower.

25 MR. POZEN: I think this is - one of the crucial

1 questions for us, is whether we would recommend that it
2 become mandatory, assuming the phase-in. I'm sure Peter
3 would argue that, by making it mandatory, then you sort of
4 assure that the software providers are going to adopt it.

5 But I do think that we, as a group, need to be
6 sensitive to the fact that - while I tend to agree with
7 Peter that this is not another 404, you know, people have
8 just gone through that, and there is a high degree of
9 sensitivity.

10 John?

11 MR. WHITE: You know, if you listened carefully to
12 Chairman Cox's press conferences -

13 MR. POZEN: We listened very carefully to all his
14 press conferences.

15 MR. WHITE: You had to be there for the questions,
16 too, to understand.

17 MR. POZEN: We hang on every word, John.

18 MR. WHITE: What he asked the staff to do - he
19 asked the staff to provide a recommendation in the spring. In
20 December, the 15,000-tag taxonomy will be put out and
21 available for comment, so a new version of that reflecting
22 comments should be available in the spring at the time the
23 staff would make a recommendation. I say recommendation, but
24 make a proposal.

25 That would give you the summer to figure out

1 whether it actually worked - the taxonomy that has been
2 developed, whether voluntary filers actually could use - if
3 they used and it worked.

4 The second part of what he said was - this was
5 actually the questions; he made his critical remarks, then he
6 was answering questions - that he was looking towards the
7 staff having a final recommendation in the fall, a big final
8 move.

9 But, obviously, you would never get to that stage
10 if you didn't get the proof with voluntary filers that the
11 new taxonomy worked. You would never go to the formal stage.

12 I also say we are very aware of the multiple sizes
13 of issuers. There aren't just two sizes; there are at least
14 three. And I think we understand tiering for phase-in.

15 MR. POZEN: Since we have about 12 minutes left, I
16 would just like to take a quick straw vote. How many support
17 going to the mandatory requirement for XBRL, assuming a much
18 more gradual segmented things - meaning, we could start with
19 something like the Fortune 500 and then move downward?
20 Anyone?

21 MS. GRIGGS: I'm concerned about liability issues
22 at the companies that don't fit into the banking mold or a
23 similar kind of mold - that tagging itself may be very
24 difficult. So I just want to reserve judgment.

25 MR. POZEN: That's a good transition because the

1 two issues that I would, at least, like to get on the table
2 before we close are - one is: What level of - I'll just
3 use the word "assurance" - auditor assurance would be
4 associated with this requirement, if any?

5 And then, second of all, the legal potential
6 liabilities.

7 And I think, Peter, it would be useful for you to
8 address both of those.

9 MR. WALLISON: Well, the committee is looking at
10 the question of assurance, and auditor liability, and company
11 liability, and so forth.

12 We have a tentative plan for how we will do that at
13 the next meeting. We want to bring in some people from the
14 AICPA and from the audit community, as well as the preparer
15 community, and talk about how an audit would be conducted, if
16 it is necessary.

17 Tentatively, we believe that it probably is not
18 necessary to do an audit of the transfer from an ordinary
19 financial statement to XBRL because exactly the same
20 information can be created from the general ledger through
21 XBRL, and all you would have to do, then, is compare the two
22 statements - the one produced in the general ledger in XBRL
23 and the one produced by hand, if the company still continued
24 to do that, using their normal system of Word.

25 So if you compare those two, and they look exactly

1 alike, then you know that there is no need to audit the
2 transfer from the financial statements made by hand to XBRL,
3 because they are identical; it has already been done. If
4 there are discrepancies, you can ask about the discrepancies
5 and, that way, you would be auditing. So I think we have a
6 way to avoid any cost of an audit associated with producing a
7 financial statement in XBRL.

8 On the general question of legal liability -

9 MR. POZEN: Before you - I understood, Peter, that
10 there were some people, at least, who thought it may need
11 some assurance that companies were, for lack of a better
12 term, sort of putting the right things in the right places.

13 MR. WALLISON: Yeah. Well, that would be the audit
14 that would be done when the general ledger is mapped to XBRL.
15 You would do that audit. And then from the general ledger
16 you can prepare your financial statements.

17 MR. POZEN: So you're contemplating sort of an
18 initial audit and a very modest process.

19 MR. WALLISON: Well, after that there is a CPA
20 audit.

21 MR. WEATHERFORD: I would have to say, having done
22 this all my life and understanding the challenges of taking
23 data out of a database and structuring it and reporting it
24 correctly, the intent may be a good intent, but I'm
25 concerned, if we start getting the auditors involved, then we

1 do create another 404.

2 And there is no doubt about it, in my mind, that is
3 what will happen, because of the litigation environment that
4 we are in today. This will be a disaster.

5 MR. POZEN: Don't hold back, Thom. Tell us what
6 you really think.

7 MR. WEATHERFORD: And, by the way, I'm for more
8 information. I think that the 10-Q today does not help
9 investors.

10 But when I heard that we start getting the auditors
11 involved in doing the transition of the data from a manual
12 spreadsheet to software - by the way, Joe had mentioned
13 earlier that Oracle and SAP should have this in their
14 software. Not every company has Oracle and SAP. There is
15 quite a few general ledger systems out there today.

16 And, even if you look at large companies, like Sun,
17 they don't necessarily have Oracle or SAP in every legal
18 entity across the world. They have a dichotomy of general
19 ledger systems, from Excel spreadsheets to outside auditors,
20 et cetera.

21 So I just think that, if we could limit on how we
22 do this, it makes sense. But, otherwise, this could become
23 greater than 404.

24 MR. DIERMIER: Thom, one of the things we
25 definitely want to understand is how the companies themselves

1 feel like they are assured that they were able to do the
2 tagging properly and that it rolled up properly to the
3 current filed statements. And I think, as we understand
4 that, I think we will have a good answer there. And then
5 some of these technology solutions, you know, they really
6 sound great, but, like you say, they haven't been tested yet.
7 So I think there's a great opportunity here.

8 MR. POZEN: I think, on the assurance thing, I
9 think we have heard the potential concerns. I think Peter is
10 very much committed to trying to figure out how to minimize
11 the cost here. I think there have been a lot of discussions
12 with the AICPA. So I just wanted to make sure that this
13 issue was flagged for the full committee because it could be
14 a potential issue - though I think Peter hopes to defuse
15 it.

16 Do you want to just say one minute about legal
17 liability?

18 MR. WALLISON: Of course, having spent most of the
19 day talking about legal liability, this is one area where I
20 don't think, actually, legal liability is likely to result.
21 And maybe, Thom, I ought talk to you offline about how this
22 whole process will work.

23 But it's no different from the process that exists
24 today, and it's not an add-on. It's one audit. And that
25 audit will result in legal liability if it's not done

1 properly by the accountant, or it will not, if it is done
2 properly. So there really isn't any change here. We are
3 exactly in the same legal status as we were before.

4 My view, of course, is that we ought to reduce the
5 legal liability by eliminating private class action suits,
6 which is really the crux of the problem -

7 MR. POZEN: This will not be within the scope of -

8 MR. DIERMIER: -- but we won't get into that here.

9 MR. POZEN: Right. Right.

10 MR. WEATHERFORD: Here is where I think that we
11 will run into a problem: Companies are dynamic. They
12 acquire companies, they spin off divisions, et cetera. They
13 bring in new software from other companies. They
14 consolidate, et cetera. So you don't have any one point in
15 time where you have the same software across your
16 organization.

17 And so to say that the auditors will look at this
18 one time - it just won't happen.

19 MR. POZEN: I think that this has been a fruitful
20 discussion. And, really, I encourage Thom and Peter to speak
21 offline because you two people are very knowledgeable about
22 this.

23 I think everybody would like to find a way to
24 introduce XBRL at the least cost and in a properly sequenced
25 way and, obviously, people want to feel comfortable about the

1 reliability of this. But we all need to be sensitive to the
2 concerns.

3 So I guess - since I promised everybody that we
4 would be out by 3 o'clock, I want to, just as an
5 administrative matter, say that we have circulated the
6 schedule for the rest of the meetings. I know that certain
7 people won't be able to make some, but we really tried hard
8 to find dates that were the most convenient to people. And
9 that wasn't easy. But I think we have a reasonable schedule.

10 I think, after this meeting, we hope that the
11 subcommittees will sort of talk and sort of prepare for their
12 next subcommittee meetings. And we are going to look for
13 January 11th, I think it is, to have the next full meeting,
14 which, I think, many of these issues that we have discussed
15 will - you know, some of them will be resolved; others will
16 have to be just continuously reported on, as we move them
17 forward.

18 Again, I would like to thank everybody on the
19 committee and the staff - Jim and Russ and all the other
20 people. I won't try to name them because I'll screw it up
21 again.

22 But, really, people should feel good. We have
23 really gotten a good start here, accomplished a lot, and
24 today has been a very high quality discussion. There are a
25 lot of very tough issues, and people have been very good

1 about reading the materials and really giving some good
2 comments.

3 So thank you all, and we will see each other on
4 January 11th at full committee and, hopefully, before that.
5 Thank you.

6 MR. KROEKER: Bob, thanks. The meeting is
7 adjourned.

8 (Whereupon, at 3:00 p.m., the meeting was
9 concluded.)

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CERTIFICATION

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I hereby certify the accuracy of this record of the proceedings of the SEC Advisory Committee on Improvements to Financial Reporting.



Robert C. Pozen
Committee Chair



Date

EXHIBIT A

**Open Meeting of the
SEC Advisory Committee on Improvements to Financial Reporting**

**Auditorium, Room L002, SEC Headquarters
Washington, D.C.**

Friday, November 2, 2007, Beginning at 9:30 A.M.

AGENDA

- I. Introductory Remarks – Robert Pozen, Committee Chairman
- II. Review of Comments Letters Received
- III. Reports from Subcommittees and Discussion:
 1. Scope
 2. Deliberations
 3. Working Hypotheses
 4. Current Status and Further Work
 5. Coordination with Other Subcommittees
- IV. Next Steps and Future Timetable
- V. Planning for January Meeting
- VI. Adjournment (expected no later than 3:00 pm)

EXHIBIT B

**SEC Advisory Committee on Improvements to Financial Reporting
Subcommittee I: Substantive Complexity
Report for Discussion at November 2, 2007 Full Committee Meeting**

This report has been prepared by the individual subcommittee and does not necessarily reflect either the views of the Committee or other members of the Committee, or the views or regulatory agenda of the Commission or its staff.

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 models¹

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

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.

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 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?

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).
- 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:

- 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.

Questions for the Full Committee:

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

Alternative accounting policies

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 level²). 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.
- 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.

²An 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.

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.***

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) .

Questions for the Full Committee:

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

Bright lines and detailed guidance

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 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).

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.

- 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 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 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
 - 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 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., 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 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.

EXHIBIT C

**SEC Advisory Committee on Improvements to Financial Reporting
Subcommittee II: Standard Setting
Report for Discussion at November 2, 2007 Full Committee Meeting**

This report has been prepared by the individual subcommittee and does not necessarily reflect either the views of the Committee or other members of the Committee, or the views or regulatory agenda of the Commission or its staff.

Introduction

Subsequent to the August 2, 2007 meeting of the Securities and Exchange Commission (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).

This report summarizes the efforts of the Standard Setting subcommittee thus far and reflects only tentative thinking in each area. After receiving input from the full committee, the subcommittee intends to continue to seek input from various constituencies in the financial reporting community in preparation for full committee consideration of certain interim recommendations in January 2008.

Members:

David Sidwell, Chair
Dennis Beresford
Scott Evans
James Quigley

Observers:

Robert Herz, FASB
Mark Olson, PCAOB

Scope of Work Plan

The subcommittee has been tasked with examining the standard setting process in the U.S. in order to make recommendations for the full committee to consider to improve the quality of financial information delivered to investors and reduce undue complexity in the financial reporting system. The Discussion Paper recommended that the subcommittee evaluate the following:

- The U.S. GAAP hierarchy.
- Characteristics of the Financial Accounting Standards Board (FASB).
- The FASB standard setting process.
- Interpretive guidance from the Emerging Issues Task Force (EITF).
- Interpretive guidance from the SEC.
- Interpretive guidance from other sources.
- The use of cost-benefit analyses in standard setting and the review of the analyses performed for particular standards.

The subcommittee agreed that all of the topics in the Discussion Paper will be included within its scope but decided to organize its evaluation of each within the following broad categories:

- Governance.
- Agenda and standard setting processes.
- Proliferation of accounting interpretations.
- Design of standards.

- International considerations.

Each category is described below, together with our related preliminary hypotheses concerning recommendations for the full committee designed to improve the quality of financial reporting and reduce undue complexity. The subcommittee acknowledges that certain of its proposals for how to improve the usefulness of the current financial reporting system may be partially or substantially addressed by actions recently taken or in the process of being taken by the FASB and SEC.

To finalize the scope of its work plan and obtain input on its preliminary hypotheses, the subcommittee intends to continue to seek input from various constituencies in the financial reporting community. In its future deliberations, the subcommittee will also reflect in its work the potential impact on the FASB's agenda associated with any recommendations from the full committee.

Questions for the Full Committee:

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

Deliberations and Preliminary Hypotheses

OVERVIEW

U.S. GAAP has evolved over many years and its basic principles have become obfuscated by detailed rules, bright lines, exceptions and regulations, which reduces the transparency and usefulness of the resulting financial reporting. In addition, interpretative guidance proliferates from a variety of sources and becomes, intentionally or not, an additional source of GAAP that can add to the complexity in the financial reporting system, especially when there are conflicts between interpretations. The fear of being second-guessed sometimes causes auditors and preparers to ask for more rules and interpretations, which further exacerbate the problem. The FASB has taken recent actions intended to reduce the proliferation of formal interpretative guidance from different bodies, including establishing itself as the sole private-sector standard setter and interpretive body in the U.S. The FASB has also undertaken a significant project to develop a comprehensive, integrated codification of existing accounting literature organized by subject matter that would become an easily retrievable single source of GAAP, but the codification by itself will not resolve the root causes of complexity. The SEC is also a source of GAAP, including through non-authoritative processes such as comment letters and staff speeches that are perceived in the marketplace to be authoritative. In addition, informal interpretations continue to be issued by other bodies (e.g., the Center for Audit Quality), which also have the perception of being authoritative.

It is the opinion of the subcommittee that the fear of having good faith judgments be second-guessed significantly influences the behavior of participants in the financial reporting community and is a key driver of much of the undue complexity in the financial reporting system. If the full committee's recommendations have the ability to defuse the fear of second-guessing by replacing it with a willingness to respect reasonable, good faith judgments made following an agreed-upon

professional judgment framework, the Advisory Committee will have met its mandate. Such a change in behavior would enable a simplification in the design of standards and would reduce the proliferation of interpretive guidance. Without such a change in behavior, meaningful improvements to financial reporting will be difficult.

In its deliberations of how the standard setting and interpretive processes in the U.S. may be improved, the subcommittee developed a number of preliminary hypotheses covering a broad spectrum of issues, many of which are inter-related. There are a few central issues that complement each other that the subcommittee would like to briefly highlight for the full committee, as follows:

1. Additional user involvement in the standard setting and regulatory processes is central to improving financial reporting. Only if user perspectives are properly considered will the output of the financial reporting process meet the needs of those for which it is intended. Additional user participation on the FAF and FASB, together with making FASB user advisory committees more effective, will help provide this perspective.
2. The SEC and FASB should work together to clarify roles and responsibilities in the standard setting and interpretive processes, which would reduce uncertainty in the financial reporting community. They should provide a roadmap of the standard setting and interpretive processes going forward that should clarify the following:
 - The FASB (and the EITF as its delegate) should be the primary issuer of broadly-applicable authoritative accounting guidance. The number of parties interpreting GAAP must be reduced by addressing the root causes of interpretations.
 - The SEC should issue registrant-specific accounting guidance and refer broadly-applicable issues to the FASB whenever possible.
 - When the SEC deems it appropriate to issue broadly-applicable authoritative accounting guidance, it should be done with appropriate due process to the extent practicable. Furthermore, the SEC should implement internal procedures to ensure that all sources of accounting guidance emanating from various Divisions and Offices within the SEC are reviewed and approved by a single Chief Accountant.
 - All other sources of accounting 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 judgment. To accomplish this, the FASB's codification project should be completed in a timely manner to clarify which guidance is authoritative versus non-authoritative and to bring to the maximum extent practicable all of U.S. GAAP into a single location.
3. A formal process should be implemented to actively manage the priorities of the standard setting and interpretive processes in the U.S. that includes representation from the regulatory, standard setting, user, preparer, and auditor communities.
4. The use of reasonable judgment should be further promoted in the way standards are both written and implemented, which would allow a reasonable amount of diversity in practice, as follows:
 - Accounting standards should be written in a manner that reflects the premise that there is trust and confidence in efficient markets through the respect of professional judgment,

rather than by attempting to prevent abuse. They 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.

- Standard setters should provide extended implementation periods for all new standards, which may allow the SEC to regulate compliance with new standards without forcing unwarranted restatements as long as the requirements in GAAP are followed.
- Formal post-adoption effectiveness reviews of new standards should be conducted within 2-3 years of implementation. By identifying divergence that developed during the implementation period that is perceived to be too great, the standard setters may take corrective action to reduce diversity through the authoritative amendment process, with appropriate transition provided to avoid unwarranted restatements.

The subcommittee believes that an appreciation of the complementary nature of the preliminary hypotheses above would provide insight into the importance of the same preliminary hypotheses described more fully, but individually, below.

GOVERNANCE

The subcommittee considered the potential ways in which (1) the SEC's delegation of standard setting authority to the FASB, and (2) the governance structure provided by the Financial Accounting Foundation (FAF) may be improved. The subcommittee believes that the SEC's delegation of standard setting to the FASB with oversight from the FAF (1) is appropriate, (2) is functioning as designed, and (3) does not contribute to complexity in a meaningful way. However, the subcommittee does have preliminary hypotheses regarding how the SEC and FASB should clarify roles and responsibilities going forward that will reduce uncertainty in the marketplace (see Preliminary Hypotheses 14-19).

Preliminary Hypothesis 1: The standard setting and regulatory processes need more individual user perspectives, which may be accomplished with more user representation, especially on both the FAF and the FASB. The subcommittee recognizes that user involvement is central to the issue of improved financial reporting, yet the intricacy of certain accounting matters and the complexity of the debate makes it difficult to attract individual users to participate in the standard setting and regulatory processes, which in turn reduces the perceived usefulness of financial statements themselves. However, it is important to strike an appropriate balance between the perspectives of users, preparers, and auditors. The subcommittee believes that the objective in the near-term should be to improve that balance by increasing consideration of the users' perspectives in the process, so that what results is an end product that meets the needs of those for which it is intended.

Future Considerations: The subcommittee will consider the role of sponsoring organizations in influencing the composition of the FAF, although the subcommittee recognizes that the sponsoring organizations currently serve in a vital nominating capacity. The subcommittee will also further consider whether and how individual FASB members represent particular constituencies and whether changes should be recommended that would increase their user focus. The subcommittee also plans to reflect on the preliminary findings of an external review of the FASB being sponsored by the FAF to determine if additional analysis of broad governance issues is justified.

Questions for the Full Committee:

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

AGENDA AND STANDARD SETTING PROCESSES

Due Process: The FASB's activities are open to public participation and observation as part of its due process procedures and the FASB actively solicits the views of its various constituencies on accounting issues. This process was designed to provide constituents with significant input into the decisions of the Board. The subcommittee believes that the FASB's approach to obtaining significant input through due process is fitting, although the subcommittee recognizes the difficult trade-off between due process and expediency. Therefore, the subcommittee is considering a number of additional preliminary hypotheses, as described below, to further enhance the standard setting process in the U.S. and improve its timeliness.

Agenda: Critics in the financial reporting community argue that the standard setting process in the U.S. is slow and they point to projects that have been on the Board's agenda for a number of years (e.g., the conceptual framework project, the revenue recognition project, the liabilities & equity project, etc.) to illustrate that there are fundamental standard setting issues that are routinely given a low priority. These critics also argue that standards that are issued are not always cohesive and may be based on several different principles. This may be due to the lack of a complete, current conceptual framework, competing priorities placed on the Board, and the evolutionary nature of standard setting in the U.S.

The FASB receives many requests for action on various financial accounting and reporting topics from all segments of its diverse constituency, including the SEC. The Board also turns to many other organizations and standing advisory committees for advice regarding its agenda, but these groups act solely in advisory capacities. There is no body that brings together the key stakeholders in the regulatory, standard setting, user, preparer, and auditor communities to actively manage priorities in the standard setting and interpretive processes. *Preliminary Hypothesis 2: A formal Agenda Committee that includes representation from the SEC, the FASB, users, preparers, and auditors should be created to provide advice on the standard setting agendas of the FASB, EITF, and SEC, while at the same time maintaining an appropriate focus on user needs. A framework should be developed that may assist the Agenda Committee with making agenda setting and prioritization decisions, including what projects to advise adding and removing from the agenda, and short-term priorities for active projects.* Future Considerations: The subcommittee will further explore (1) the structure of and representation on the Agenda Committee, including how to ensure that the SEC has a strong voice regarding the agenda (see Preliminary Hypothesis 17), (2) how to ensure that the scope of new projects is clear prior to commencing work, (3) whether to require a supermajority for adding projects to the FASB's agenda, which may encourage addressing only standard setting and interpretive issues with widely acknowledged needs, and (4) the impact of the existence of an Agenda Committee on the activities of various other FASB advisory groups.

Preliminary Hypothesis 3: Although highly dependent upon the conclusions reached in International Considerations as described below, the subcommittee is exploring a recommendation for the full committee to consider that the FASB re-prioritize its existing agenda, which may include the following:

1. Consider the full committee's recommendations and the potential prioritization of those recommendations.
2. Finalize the codification of U.S. GAAP on a timely basis.
3. Continue efforts towards international convergence.
4. Complete the conceptual framework (jointly with the IASB).
5. As phase II of the codification project, consider whether GAAP should be systematically revisited, as follows:
 - To be more coherent post codification.
 - To remove redundancies.
 - To be less complex, where possible.
 - To be more principles-based.
 - To readdress frequent practice problems (as identified by restatement volumes, input from the SEC, recent interpretations, and frequently-asked questions).
 - To readdress outdated standards (i.e., sunseting).
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.
7. Address emerging issues that urgently require attention (either directly or through the EITF as its delegate).

Preliminary Hypothesis 4: In addition, the subcommittee may also recommend that the full committee consider recommending that the SEC work with the FASB to:

1. Remove any redundancy between SEC disclosure requirements and other sources of GAAP.
2. Consider taking steps so that the SEC guidance to be included in the codification will conform to the extent possible with the rest of the format of the codification.
3. As phase II of the codification project, consider whether SEC literature should be systematically revisited and integrated with FASB guidance.

Conceptual Framework: The subcommittee believes that the completion of the conceptual framework, and a reconsideration of conflicts between the revised framework and U.S. GAAP, will be an important step to reduce inconsistencies in GAAP and improve the coherence of the reporting framework. Specifically, Board members should have such a framework that they may refer back to over time when standard setting to ensure cohesiveness and consistency in GAAP. The subcommittee acknowledges that many of the issues currently being addressed by the Board as part of the conceptual framework project are challenging and will have a pervasive impact on U.S. GAAP. Therefore, it will be important that constituents agree with the direction of the FASB and to do so, there may be opportunities during Board deliberations to further clarify what the specific impact of recommended changes to the conceptual framework will have on the full body of GAAP.

Objectives: The subcommittee reflected on the FASB's published objectives and precepts for standard setting. The subcommittee plans to evaluate possible changes to the FASB's objectives and precepts that may provide guidance to the Board when balancing competing priorities in the future. *Preliminary Hypothesis 5: Two possible recommendations for the full committee to consider*

may be that (1) certain objectives should be given more emphasis, and (2) an objective should be added that accounting models should not introduce unnecessary complexity (i.e., not be more complex than the underlying transactions).

Advisory Groups: As noted above in Preliminary Hypothesis 1, the subcommittee believes that there is a need for greater individual user involvement throughout the standard setting process. The FASB has a number of standing advisory groups and committees that it consults on technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces, and other matters. Future Considerations: The subcommittee is in the process of considering (1) whether the FASB makes effective use of its advisory groups, and (2) what other mechanisms may be effective in ensuring that sufficient input is received by appropriate parties and at the right time during the standard setting process. The subcommittee will also further consider how user involvement may be more effectively managed and made more transparent so that interested parties know when and how to engage the FASB and its staff to assist in standard setting.

Staffing: The subcommittee is also concerned that the organization and composition of its staff may constrain the FASB. Preliminary Hypothesis 6: *The FASB should consider an alternate staffing model that makes use of preparers, users, and auditors either directly or through task forces and resource groups (perhaps on a rotational basis) to bring additional subject matter expertise and recent business experience to each standard setting activity.* Such resources might be leveraged to do original thinking on new projects, assist in field testing, estimate the costs of implementing new standards, or serve as subject matter experts to the FASB's staff.

Preliminary Hypothesis 7: *The FASB's Major Projects and Technical Analysis & Interpretations groups should be combined and organized by subject matter expertise to:*

- *Ensure that major projects are led by subject matter experts.*
- *Ensure that interpretive issues are addressed by the same group involved in setting the standards.*
- *Facilitate inclusion of interpretive accounting guidance in the codified standards.*
- *Increase the interaction with relevant financial reporting constituents, resource groups, and alternate staff who have the same subject matter expertise.*

Field Testing and Cost Benefit Analysis: 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 are difficult to assess prior to preparers using the standard in the preparation of financial statements, auditors auditing that information, and users assessing the benefits of the resulting accounting and disclosure. Preliminary Hypothesis 8: *The subcommittee is considering a recommendation to the full committee that the FASB improve its procedures for field testing, field visits, and cost-benefit analyses, such that:*

- *Field tests and field visits should be required to be integrated into the standard setting process for all new standards.*

- *Cost-benefit analyses should be required to be performed as part of the field tests.*
- *This additional work should leverage the alternate staffing model described above. Specifically, the FASB should leverage work already being done by preparers, auditors, task forces, and user groups to assess the impact, operationality, and auditability of proposed standards to help inform its views.*

The Discussion Paper proposed the review of previously-issued standards to understand cost-benefit analyses performed by the FASB, but the subcommittee decided that sufficient information regarding the efficacy of cost-benefit analyses may be obtained without performing a detailed review with reference to specific standards. Future Considerations: The subcommittee intends to also consider guidance from economists regarding whether there are other opportunities for the FASB to improve its cost-benefit analyses.

Fatal Flaw Reviews: *Preliminary Hypothesis 9: The review of near-final standards immediately prior to final release (sometimes referred to as fatal flaw reviews) should be more formalized.* Such a formalized review may identify unintended consequences of changes made since the previously-exposed drafts and may provide an additional opportunity for user involvement, given the near-final nature of the standard or interpretation. Currently, the IASB posts near-final exposure drafts to its website to facilitate such reviews by interested parties.

Post-Adoption Effectiveness Reviews: After a new accounting standard has been in place for multiple financial reporting cycles, more data may be available to evaluate its cost, efficacy, utility, and/or relevance in the current environment. However, currently the FASB does not have a process in place to do post-adoption effectiveness reviews of new standards. As a result, standards may miss important matters, not properly consider implementation issues, have unintended consequences, and as a result, may lose their relevance and effectiveness. As such, useful financial information might not be made available to the users of financial statements. Preliminary Hypothesis 10: *The FASB should conduct formal post-adoption effectiveness reviews of new standards within 2-3 years of implementation to:*

- *Ensure that the accounting that is being produced is what the FASB intended and is useful to readers of the financial statements.*
- *Re-assess the cost-benefit analyses.*
- *Deal with interpretive matters that arise.*
- *Ensure that only an acceptable amount of diversity in practice exists.*

As noted in Preliminary Hypotheses 3 and 4, Preliminary Hypothesis 11: *A review of all of U.S. GAAP should be performed periodically by the SEC and the FASB and should formally consider (1) restatement activity, (2) practice problems identified by the SEC, (3) the number of interpretations required since that last post-adoption effectiveness review, and (4) opportunities for simplification and sunseting.*

Promoting Reasonable Interpretations: The subcommittee also noted that one of the significant complexities of the current financial reporting and regulatory environment is that preparers, auditors, and other participants are sometimes penalized for improving their understanding and interpretations of accounting standards over time. This issue is especially problematic for new standards. Preliminary Hypothesis 12: *The FASB should provide 2-3 year extended implementation*

periods for all new standards prior to the first formal post-effectiveness review, during which time preparers may benefit from authoritative or non-authoritative implementation guidance to learn about how the standard is being interpreted and implemented without being forced to restate (except in egregious cases at the SEC's discretion in which the registrant clearly fails to apply the requirements of the standard). Such an extended implementation period would likely require the FASB to adopt standard transition guidance applicable to all new standards and may have the effect of allowing the SEC to satisfy its regulatory mandate of investor protection and capital formation in a more flexible manner. This complements Preliminary Hypotheses 2, 10, 11, and 17. Issues arising during this process that are of an interpretive nature (other than clear violations of the standards, as determined by the SEC) would be re-considered by the FASB either during or at the end of the implementation period and authoritative amendments would be completed by the FASB to clarify the standard and reduce diversity in practice, as necessary.

The subcommittee does not mean to imply that it is considering recommending a move away from comparability in financial reporting; on the contrary, such post-adoption effectiveness reviews after an extended 2-3 year implementation period would actively manage comparability. By identifying divergence that developed during the implementation period that is perceived to be too great, the FASB may take corrective action to reduce diversity through the authoritative amendment process, with appropriate transition provided to avoid unwarranted restatements. Therefore, the subcommittee's preliminary thinking represents a shift in attitude away from the stark emphasis on comparability at any cost towards a careful evaluation of when diversity in practice becomes too great that it must be reigned-in. This is one reason why enhanced individual user involvement in Preliminary Hypothesis 1 is central to the subcommittee's other preliminary hypotheses.

Future Consideration: The subcommittee will further consider whether the standard implementation and transition guidance noted above should have a bias towards prospective or retrospective application.

Questions for the Full Committee:

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

PROLIFERATION OF ACCOUNTING INTERPRETATIONS

Codification: The subcommittee believes that there are too many sources of authoritative accounting guidance in U.S. GAAP. Interpretations of U.S. GAAP have proliferated over a number of years from a variety of sources. Often interpretive accounting guidance that is not formally authoritative is erroneously perceived by participants in the financial reporting and legal communities to be additional sources of authoritative GAAP. This adds to complexity in the financial reporting system, especially if there are conflicts between these accounting interpretations. With that in mind, the subcommittee is considering Preliminary Hypothesis 13: The FASB's codification project should be completed in a timely manner so that the flattening of the GAAP hierarchy into authoritative and non-authoritative accounting guidance will be completed as quickly as practical. As part of the codification validation process, the SEC should ensure that all

accounting guidance it deems to be authoritative is included in the codification to the extent practicable. The completion of the codification project (which will (1) flatten the GAAP Hierarchy to two levels, and (2) clarify explicitly those sources that are authoritative and those that are not) is an important aspect of Preliminary Hypotheses 14-19.

Clarify Roles and Responsibilities: The subcommittee hypothesizes that certain changes that clarify how the SEC and FASB should interact will further improve financial reporting, as follows:

- *Preliminary Hypothesis 14: Authoritative accounting guidance that is broadly applicable is best issued by a single, private-sector standard-setter (e.g., the FASB and the EITF as its delegate) such that the guidance may be immediately updated in the codified version of GAAP. This hypothesis is based upon the presumption that the SEC will continue to be judicious when determining when to issue its own guidance (see Preliminary Hypotheses 17-18).*
- *Preliminary Hypothesis 15: Authoritative accounting guidance that is applicable only to specific registrants should be given solely by the SEC and should not be required to be applied more broadly. This will require more formal coordination within the SEC, as noted below.*
- *Preliminary Hypothesis 16: All precedent-setting accounting guidance applicable either broadly or to specific registrants (e.g., staff interpretations, speeches, information posted to its website, etc.) should be reviewed and approved by a single Chief Accountant. This will help to ensure consistency in the accounting conclusions that drive regulatory actions taken by various Divisions and Offices within the SEC. In future deliberations, the subcommittee will also consider the impact of caveat language commonly included on SEC staff guidance stating that it is either non-authoritative or does not represent the views of the SEC on the perception in the marketplace that it is non-authoritative.*
- *Preliminary Hypothesis 17: The SEC and the FASB should establish a formalized mechanism in which the SEC may refer agenda topics to the FASB such that the FASB (or the EITF as its delegate) can deliberate and issue authoritative accounting guidance that is broadly applicable, thereby reducing the need for the SEC to do so. Such a process would leverage the Agenda Committee described above in Preliminary Hypothesis 2, and the post-adoption effectiveness reviews described above in Preliminary Hypotheses 10 and 11, but may also require an additional ongoing communication process, to be further considered by the subcommittee. This would have the effect of specific registrant matters that have broad applicability being formally referred from the SEC Division of Corporation Finance to the SEC Office of the Chief Accountant to the FASB. Such a formal, transparent feedback loop would identify and prioritize issues with broad applicability that require immediate, authoritative accounting guidance from the FASB (or the EITF as its delegate) directly in the codified version of GAAP.*
- There may continue to be instances, albeit rare, when the FASB and EITF are unwilling or ineffective at addressing practice issues raised by the SEC. *Preliminary Hypothesis 18: Any accounting guidance issued by the SEC that is broadly applicable should to the extent*

practicable be (1) subject to due process, including public comment, and (2) easily integrated into the GAAP codification. Preliminary Hypotheses 8-12 would also apply to the SEC when issuing such standards or interpretations.

- *Preliminary Hypothesis 19: All non-authoritative accounting guidance (including that which has historically been communicated in industry guides, SEC speeches, accounting firm guidance, etc.) should be clarified to be non-authoritative (by virtue of the fact that it will not be included in the codification) and would therefore not have more credence than well-reasoned, documented conclusions based on other, potentially-conflicting non-authoritative accounting guidance applied using a professional judgment framework. Although the FASB codification initiative will help alleviate some of the proliferation of accounting interpretations by including only authoritative accounting guidance, making meaningful improvements in financial reporting will be difficult if non-authoritative accounting guidance continues to have the perception it has today of pseudo-authority in the marketplace.*

In summary, Preliminary Hypotheses 14-19 reflect the subcommittee's tentative thinking that roles and responsibilities in the standard setting process could be clarified in such a way as to reduce uncertainty in the financial reporting community by:

1. Flattening the GAAP Hierarchy.
2. Providing a roadmap of the standard setting process going forward that clarifies that:
 - The FASB (and the EITF as its delegate) should be the sole issuer of broadly-applicable authoritative accounting guidance.
 - The SEC should issue registrant-specific accounting guidance and refer broadly-applicable issues to the FASB whenever possible.
 - When the SEC deems it appropriate to issue broadly-applicable authoritative accounting guidance, it should be done with appropriate due process to the extent practicable.
 - All other sources of accounting guidance would be considered non-authoritative and need not be given any more credence than any other non-authoritative sources that are evaluated using well-reasoned, documented professional judgment.

The subcommittee does not intend for the SEC's authority to (1) oversee the private-sector standard setting body, (2) set standards, or (3) regulate the capital markets be usurped in any way. Rather, Preliminary Hypotheses 14-15 will improve the clarity around what standard setter should provide guidance and what that guidance should ideally include. The SEC will continue to have ultimate authority, but Preliminary Hypothesis 18 is based upon the presumption that the SEC will continue to be judicious when determining when to issue its own guidance. Preliminary Hypothesis 16 will enhance the consistency of accounting guidance provided by the SEC to reduce the instances of mixed messages being communicated in the marketplace. Preliminary Hypothesis 17 recommends that the SEC continue to improve its oversight of the FASB by implementing a formal, transparent feedback loop. And Preliminary Hypothesis 19 clarifies that non-authoritative guidance should not be used to force restatements when other reasonable views exist. Taken together, this would be a significant change in practice.

Further Considerations: The subcommittee will further consider how to make these preliminary hypotheses operational. In its future deliberations, the subcommittee will evaluate other root causes

of the proliferation of accounting interpretations to identify whether there are other changes that are necessary in the regulatory environment to reduce the need for multiple parties to informally interpret GAAP.

Questions for the Full Committee:

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

DESIGN OF STANDARDS

Some participants in the financial reporting community believe that accounting standards do not clearly articulate the objectives and principles upon which they are based. The subcommittee believes the objectives and principles inherent in existing U.S. GAAP are obfuscated by detailed rules, examples, scope exceptions, safe harbors, cliffs, thresholds, and bright lines. This makes it difficult for preparers and auditors to apply the standard's underlying objectives and principles, causing difficulty and uncertainty in application, because rules cannot cover all possibilities and create additional risk that the appropriate rule is not identified and considered. 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. The result is an accounting system that is overly complex, has little room for professional judgment, and can engender a check-the-box approach. As such, the subcommittee is considering *Preliminary Hypothesis 20: Accounting standards should be written in a manner that reflects the premise that there is trust and confidence in efficient markets through the respect of professional judgment, rather than by attempting to prevent abuse.*

Similarly, the FASB's codification project is progressing at a rapid pace, yet participants in the U.S. financial reporting community have not built consensus about what standards should look like. As part of its deliberations, the subcommittee is considering what an ideal accounting standard should look like and whether a framework should be created that the standard setter may refer back to over time to ensure that these ideals are maintained. *Preliminary Hypothesis 21: Characteristics for the potential framework that are being evaluated include that accounting standards should:*

- *Faithfully represent the economic consequences of transactions.*
- *Be decision-useful and promote transparency.*
- *Be consistent with the FASB's conceptual framework.*
- *Have an appropriately-defined scope that addresses a broad area of accounting.*
- *Be written clearly and concisely in plain language.*
- *Have an appropriate balance between principles, explanations, examples, and other guidance based on the complexity of the transactions.*
- *Minimize rules, exceptions to the scope and principles, safe harbors, cliffs, thresholds, and bright lines.*
- *Allow for the use of well-reasoned, documented professional judgment, where appropriate, with transparent disclosure.*

Future Consideration: Once the subcommittee's perspectives about the design of standards is more complete, the subcommittee will further consider the approach that should be taken to migrate the codified version of U.S. GAAP to this ideal.

Questions for the Full Committee:

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

INTERNATIONAL CONSIDERATIONS

Future Considerations: The subcommittee has deferred full discussion of international considerations until comments have been received and evaluated by the SEC on (1) the proposal to remove the U.S. GAAP reconciliation for foreign-private issuers reporting under IFRS as promulgated by the IASB, and (2) the concept release on the possibility of allowing domestic issuers to report under IFRS as promulgated by the IASB. The subcommittee believes that international considerations should be included within its scope, because:

- It would be difficult to address standard setting in the U.S. without discussing convergence matters, especially given that the FASB's agenda is heavily influenced by convergence efforts.
- Convergence matters have in the past created conflicts in the Board's priorities.
- Differences between U.S. GAAP and IFRS are an additional source of confusion.
- Allowing domestic issuers to report under IFRS as promulgated by the IASB would be a significant change from today's process.

The subcommittee believes that many of the preliminary hypotheses contained herein are equally applicable to the International Accounting Standards Board (IASB), with minor modifications. Therefore, international considerations are already implicit in the subcommittee's deliberations. Nevertheless, the subcommittee will defer in-depth discussion of international considerations until 2008.

Questions for the Full Committee:

- 1) Does the full committee agree with the subcommittee's intention to defer deliberations of international considerations associated with standard setting until 2008?

Current Status and Further Work

The subcommittee will continue to meet on a frequent basis with a goal of finalizing certain of its preliminary hypotheses for full committee consideration in January 2008 and publication as interim recommendations. The subcommittee is also planning to obtain further input on its preliminary hypotheses from various constituents in the financial reporting community. As noted above, international considerations will impact these recommendations and will be further deliberated in early 2008.

Coordination with Other Subcommittees

The subcommittee wishes to refer to the Audit Process and Compliance subcommittee work regarding a framework for professional judgment.

EXHIBIT D

**SEC Advisory Committee on Improvements to Financial Reporting
Subcommittee III: Audit Process and Compliance
Report for Discussion at November 2, 2007 Full Committee Meeting**

This report has been prepared by the individual subcommittee and does not necessarily reflect either the views of the Committee or other members of the Committee, or the views or regulatory agenda of the Commission or its staff.

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 Audit Process and Compliance subcommittee thus far. At the November 2, 2007 full committee meeting, the subcommittee will present this report for discussion by the full committee.

Members: Mike Cook, Chair
Ed Nusbaum
Greg Jonas
Linda Griggs

Observers: Larry Smith, FASB (Observer for FASB Chairman Robert Herz)
Dan Goelzer, 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:

- Financial Restatements
- Use of Judgment
- Regulation and Compliance issues including
 - PCAOB
 - SEC
 - Audit Firms

The subcommittee has concentrated its efforts to date primarily on the subject of Financial Restatements and whether the provision of guidance with respect to the materiality of errors would be beneficial, with some limited discussion on the Use of Judgment and whether a judgment framework would enhance the exercise of judgment. The Subcommittee intends to finalize recommendations on Financial Restatements for the January full committee meeting, and then focus on the impact of the PCAOB, the SEC and audit firms on complexity of financial reporting and the exercise of judgment.

Questions for the Full Committee:

- 3) Does the full committee agree with the subcommittee's preliminary scope, which we believe is consistent with the original discussion paper?

Deliberations and Preliminary Hypotheses

Financial Restatements

Potential causes of restatements

A significant and increasing number of restatements have occurred in the U.S. financial markets over the past few years. Some have attributed these restatements to more rigorous interpretations of accounting and reporting standards by preparers, outside auditors, the SEC and the PCAOB, while others believe the concept of materiality⁴ (and discussions regarding materiality in SEC Staff Accounting Bulletin (SAB) 99 (as codified in SAB topic 1M)) is applied too broadly (i.e. resulting in errors being deemed to be material when an investor may not find them to be important). The subcommittee considered the potential causes of restatements and concluded that complex accounting standards, such as classification of equity instruments as liabilities or equity, do create an environment that leads to an increased potential for restatements. The subcommittee believes that standard setters should closely monitor restatement trends to determine if there are particular areas where the current accounting standards could be improved (for example, the FASB could consider prioritizing its liabilities and equity project due to the high number of restatements in this area) to prevent restatements. The subcommittee understands from Chairman Pozen's Discussion Paper that another CIFIIR subcommittee is looking into the standard setting process. The subcommittee believes that there is potential benefit in the short term in examining the concept, application and guidance regarding materiality, and the process for restatements.

Research by Subcommittee

The subcommittee undertook a review of several publicly available studies on restatements, including 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 subcommittee also reviewed 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. The subcommittee understands that the Treasury Department also has recently announced the selection of University of Kansas Professor Susan Scholz to conduct an examination of the impact of and the reasons

⁴ 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).

behind public company financial restatements. The subcommittee will monitor the Treasury Department's study and incorporate its findings as they are made available.

The restatement studies reviewed all indicate that the number of restatements has increased in recent years. The subcommittee believes that market reaction can be one factor relevant in evaluating materiality, and based on these studies it would appear that there may be many restatements occurring that investors do not consider important due to a lack of a statistically significant market reaction. While there are limitations to using market reaction as a proxy for materiality, the subcommittee believes that these studies indicate that a reduction in the number of restatements is appropriate and worth trying to achieve. Examples of the limitations 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) that the impact on the market of factors other than the restatement and 3) the disclosure at the time of the restatement of positive information, such as an earnings release, that may have an offsetting positive market reaction. The subcommittee believes that additional guidance on applying materiality in the context of determining whether a restatement is necessary may be beneficial to achieve that outcome.

The subcommittee also gathered input from equity and credit analysts and others about investor's 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.
- One of the major costs of restatements for investors is the amount of time between the restatement announcement and the final resolution of the restatement, including potential delisting of the company's stock.
- The disclosure provided on restatements is not adequate. Notably, the disclosure does not clearly explain how the error was detected and why the restatement occurred.
- Interim periods should be viewed as discrete periods for purposes of making materiality judgments.

Prospective Accounting for Errors

Some have suggested that current investors would be better served if certain accounting changes were made prospectively (for purposes of this discussion, prospective accounting refers only to the method by which an error is corrected, specifically a cumulative correction in the current period, and not the timing of when the correction is made, such as when a filing is amended with the Commission), rather than through restatement. This would reserve restatements for only the most severe errors (i.e., those that were made intentionally, involved fraud, significantly misrepresented a company's financial performance, etc.). Under such a view, misapplications of technical accounting literature would perhaps not always result in restatements of prior period financial statements. Under SFAS 154 (and previously APB 20), a correction of a material error must be reflected as a restatement. Since current GAAP requires that any material error be accounted for as a restatement, this issue may be inseparable from the consideration of materiality standards.

The subcommittee looked into the option of prospective accounting for errors and considered the following issues associated with prospective accounting treatment:

- If changes were made to SFAS 154 to allow for the prospective treatment of certain material errors, yet retrospective accounting for other material errors, adding another choice to the process could potentially increase the complexity related to the restatement process and would force people to make judgments regarding not only the materiality of an error, but also the severity of the error.
- If some or all material errors were accounted for as a cumulative correction in a current period, then the impact on historical periods would not be presented to investors. Investors may use historical periods in part to obtain information to project the future of a company. If an error is material, in that it would alter the total mix of information an investor would consider, then prospective accounting treatment may not provide sufficiently complete information to investors.
- In evaluating whether prior financial statements should be restated, should the needs of both current and prior investors be considered? A material error may be less important to a current investor due to, for example, the amount of time that has passed since the period in which the error originated, but would have been important to an investor during the originating period.

Based on consideration of the above issues and feedback that the subcommittee received during its deliberations, the subcommittee's preliminary finding is that the determination whether historical financial statements should be restated should be based on the interests of current investors, with sufficient disclosure to inform prior investors about errors that were not determined to be important to current investors. The subcommittee also believes that, if an error in a period that is still relevant to current investors is material, then retrospective treatment is generally the appropriate method of accounting for the error.

Preliminary findings regarding Restatements

Based on its work to date, the subcommittee has developed the following list of preliminary findings for consideration by the full committee.

A. Materiality

1. The subcommittee believes that those who judge the need for restatement of financial statements because of an error should make the decision based upon the current investor's interests. The subcommittee believes that too many restatement judgments are being made in practice without full consideration of how a current investor would evaluate the error. One improvement to this process could be to look at analysts' investment models or credit rating models to determine the impact of an error. For example, the major credit rating agencies publish their credit ratings models (as do many sell-side investment analysts). One could take these models and determine the impact of the error on a company's indicated credit rating (or analyst estimated market price). Another potential improvement to making judgments with respect to the need for restatement to correct an error would be for a company to consult with independent valuation experts (such as firms that would provide fairness opinions) to evaluate the potential impact of an error from an investor's perspective.

2. The subcommittee believes that quantitatively significant errors are presumptively material but that, in certain circumstances, qualitative factors can make a quantitatively significant error not be material (See Appendix A to this memorandum for a listing of certain qualitative factors the subcommittee believes would be relevant to this evaluation). The subcommittee 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 subcommittee believes that materiality guidance should be similar in both directions. Specifically, the subcommittee 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. For example, depending on the individual circumstances of a company, errors that were less than 5% of pretax earnings would have a rebuttable presumption that the error is not material, while errors that were in excess of 10% of pretax earnings would have a rebuttable presumption that the error is material. The subcommittee believes that judgments regarding the need for a restatement of financial statements should be made based on the total mix of information available to investors.
3. The subcommittee believes that the goal of companies should be to record errors, excluding clearly insignificant errors and errors resulting from normal accounting conventions, no later than in the financial statements of the period in which the error was discovered.

B. Restatement Process

1. The subcommittee believes that the current disclosure surrounding a restatement is not adequate. The subcommittee believes that all companies that have a restatement should be required to disclose the following information, in addition to the amount of the restatement and the periods impacted, with prominent location within a filing with the SEC:
 - How the restatement was discovered
 - Why the restatement occurred, including clear disclosure of any control weakness that led to the restatement, even if the control weakness was not determined to be a material weakness.
 - Corrective actions, if any, taken by the company to prevent the error from occurring in the future
2. The subcommittee believes that one of the major costs to investors related to restatements is the lack of information caused when companies are silent during the restatement process. The subcommittee understands that in the current legal environment, companies are often unwilling to provide disclosure of uncertain information. The subcommittee believes that when companies are going through the restatement process, they should be encouraged to continue to provide financial information so that investors understand the company’s results and financial condition as much as possible. Therefore, the subcommittee is considering whether the full

committee should recommend that the Commission consider establishing guidelines whereby a company could have a safe-harbor to disclose this information assuming the company provided appropriate disclosure to investors regarding the potential uncertainty of the information.

3. The subcommittee believes that the need to amend prior filings should be revisited. Currently, a restatement may result in the need for immediate amendment of many separate filings across multiple periods. The subcommittee believes that certain restatements may not require immediate action (the amendment could occur during the next regular periodic filing for a company) and that in the majority of situations, only the financial statements that would be included in a company's most recent filing would require restatement. The subcommittee believes that the guidance in this area should be revisited to develop a framework that suits the needs of current investors.

C. Areas under Further Consideration

- Materiality related to interim periods – Based on the restatement studies the subcommittee examined, approximately one-third of all restatements related to interim periods. However, there is not currently much authoritative guidance on assessing materiality with respect to interim periods outside of paragraph 29 of APB 28, *Interim Financial Reporting*⁵, which was issued over 30 years ago in an environment where interim reporting was viewed differently than today. Current practice on this issue is mixed. Some people view that APB 28 allows all materiality judgments to be made based on the impact of an error on the annual period. Others believe that errors in the current interim periods should be evaluated solely on the basis of the impact of the error on the interim period. The subcommittee is leaning towards a recommendation based on the latter view with the caveat that errors that originated in an interim period (these errors would be evaluated based on the impact to the interim period) would be distinguished from the cumulative effect of catching up a prior period error in the current interim period (these would be evaluated based on the impact to the current annual period). The subcommittee plans additional deliberations on this subject.
- Errors related to the cash flow statement and balance sheet and errors related solely to financial statement disclosures – Restatements due to classification errors continue to increase. SAB Topic 1M does not explicitly address errors in the cash flow statement or the balance sheet. Therefore, in practice, many preparers and auditors will evaluate the magnitude of a balance sheet or cash flow statement error in the same manner that they would evaluate an error that affected net income or total equity. This includes classification errors on the balance sheet or cash flow statement. The subcommittee plans to explore if additional guidance on evaluating the materiality of balance sheet and cash flow statement errors would be helpful and what quantitative or qualitative factors should be considered when evaluating these errors. In addition, the subcommittee plans to explore if additional guidance on evaluating errors that relate solely to a financial statement disclosure would be helpful in reducing restatements.

⁵ “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.”

Questions for the Full Committee:

- 3) Does the full committee agree with the subcommittee's preliminary findings regarding materiality guidance with respect to the need for restatements of historical financial statements? What changes, if any, would the full committee suggest?
- 4) Does the full committee agree with the subcommittee's preliminary recommendations regarding the restatement process? What changes, if any, would the full committee suggest?
- 5) Does the full committee agree with the subcommittee's leanings regarding the areas still under further consideration? What changes, if any, would the full committee suggest?

Professional Judgment

Companies and auditors agree, in principle, that a system in which professionals can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction is preferable to a checklist-based approach. However, both groups continue to express skepticism that such a system could be fully successful without confidence that reasonable judgments would be respected. Regulators assert that they do respect reasonable judgments, but also express concern that companies and auditors attempt to defend certain clear cut errors as "reasonable judgments."

The subcommittee is exploring the development of a recommendation to the full committee regarding a "professional judgment framework" that could potentially serve as a safe-harbor when accounting judgments are required. An agreed-upon framework may provide companies and auditors comfort that the chances of being second-guessed have been sufficiently mitigated. A framework could also potentially address concerns by investors and others by instilling discipline in management's processes.

Framework elements

The subcommittee is considering a framework with 3 broad elements; accounting; documentation; and disclosure. Are each of these elements valid? Should the Subcommittee consider other elements?

Accounting

- Should the proposed framework suggest that a judgment be made based on an assessment of the most transparent way to display the economic substance of the transaction or the accounting treatment that results in a "highest common denominator"? Would this imply that any conclusion that would not result in the most transparent way to display the economic substance of the transaction or the most preferable accounting could be questioned?
- Should the proposed framework suggest that a judgment be made based upon a reasonable analysis of the relevant accounting literature"?
- Should the framework include discussion of the business purpose related to the accounting or auditing issue subject to the judgment?

- Should the framework measure judgment against accounting principles and consistency of a judgment with those principles?
- Should the framework consider other accounting-related criteria?

Documentation

- Should the proposed framework require that the basis for conclusions and alternatives considered and documented contemporaneously? That is, was the issue thoroughly considered before management filed the financial statements with the Commission?
- Should the framework include guidance on the levels of review a professional judgment should go through (e.g., was the audit committee or were the external auditors involved, or did the judgment involve sufficient internal or external subject matter experts)?

Disclosure

- Should the proposed framework contain a standard of “Was the accounting method transparently disclosed, such that all pertinent information was available to investors?”

Other Issues

- Would a framework actually help with reducing the potential for second guessing related to professional judgments, or does it simply replace the evaluation of the original judgment with evaluations of the sufficiency of the accounting conclusion, the documentation, and the disclosure of the issue?
- How should the framework address the issue of hindsight (those who would evaluate the judgment would have more information available to them than the person(s) making the judgment)?
- Should the recommendation be that the framework be set up as a safe-harbor, or should the framework be guidance from the Commission that is intended to provide insight on what the Commission would consider when evaluating professional judgments? If this framework were set up as a safe-harbor, from what is it providing a safe-harbor?
- Should the subcommittee consider a similar framework for auditors? What types of factors should a framework for auditors include?

Questions for the Full Committee:

- 1) Does the full committee agree with the subcommittee's preliminary leanings that a professional judgment framework could be useful or should the subcommittee focus more on providing guidance on the use of professional judgment? What changes, if any, would the full committee suggest?
- 2) Does the full committee have any comments or inputs into the questions the subcommittee is deliberating regarding a potential professional judgment framework?

Current Status and Further Work

The subcommittee expects to finalize its findings regarding restatements and materiality guidance for the January 2008 full committee meeting.

The subcommittee expects to focus on the issue of professional judgment and attempt to have preliminary recommendations for the January 2008 full committee meeting.

The subcommittee plans to focus on regulation and compliance issues after the January 2008 full committee meeting.

Coordination with Other Subcommittees

The subcommittee is referring to Subcommittee II the issue of having standard setters review restatement studies to determine if there are areas, indicated by a high number of similar restatements, where either current standards need to be reassessed or new standards are needed.

Appendix A
Tentative List of Qualitative Factors that Could Result In
Large Errors Being Immaterial

Concepts:

- By definition, materiality is judged through the eyes of a “reasonable” investor. Thus, those that judge materiality to an investor must understand investors’ models and perspectives, to determine whether an error is material to an investors’ valuation or assessment of risk.
- Qualitative factors about an error can both lower and raise its relative importance to a reasonable investor. Thus, it is possible that errors could be quantitatively large, but still not be important to investors. This view is in contrast to how SAB Topic 1M is often applied in practice, which tends to view qualitative factors as a one-way street that can only scope in more items as material.

There follow examples of some of the qualitative factors that could result in concluding 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 the investors’ conclusions or are not important to the investors’ models.
- Errors that investors view as affecting a single period rather than affecting an ongoing trend.
- The misstatement does not impact investors’ impressions of key trends they deem important.
- The misstatement does not impact a business segment or other portion of the registrant's business that investors see as driving valuation or risks.
- Errors that occurred in the distant past (e.g. more than 5 years ago) for which the correction would not be useful to current investors.
- Errors that relate to financial statement items whose measurement are inherently highly imprecise.
- The market’s reaction to initial press release disclosures about the error are small.

EXHIBIT E

**SEC Advisory Committee on Improvements to Financial Reporting
Subcommittee 4: Delivering Financial Information
Report for Discussion at November 2, 2007 Full Committee Meeting**

This report has been prepared by the individual subcommittee and does not necessarily reflect either the views of the Committee or other members of the Committee, or the views or regulatory agenda of the Commission or its staff.

Introduction

Subsequent to the August 2, 2007 meeting of the SEC Advisory Committee on Improvements to Financial Reporting (Advisory Committee), committee members 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 Delivering Financial Information subcommittee thus far. At the November 2, 2007 full committee meeting, the subcommittee will present this report for discussion by the full committee.

Members: Jeffrey Diermeier, Chair
Christopher Liddell
William Mann
Peter Wallison

Observer: Donald Young, FASB (observer for FASB Chairman Robert Herz)

Scope of Work Plan

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

- Delivering Financial Information to Investors Generally
- Use of Summary Reports
- Tagging of Financial Information (XBRL)
- Press Releases and Website Disclosures
- Disclosures of Key Performance Indicators and Enhanced Business Reporting

The subcommittee 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 subcommittee has recognized that the information needs of different types of investors are not always the same. The subcommittee 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 subcommittee 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.⁶ The subcommittee believes that it can provide some useful recommendations to enhance ongoing reporting that will enable investors to better understand reporting companies.

In furtherance of its work, the subcommittee has interviewed representatives of various constituents of the financial reporting process regarding the use of XBRL and intends to approach additional market representatives regarding issues relating to the use of XBRL under the Exchange Act reporting regime. The subcommittee also intends to evaluate further other information disclosure models, including those involving enhanced uses of technology.

Question for the Full Committee:

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

Deliberations and Preliminary Hypotheses

Use of Summary Reports

To address the information delivery issues, the subcommittee segmented retail and institutional investors. At the retail level, the subcommittee particularly targeted the serious retail investor as the primary beneficiary of improved company financial reporting. The subcommittee noted that serious retail investors may be persons who have concentrated holdings due to family or employment and, therefore, have a need to understand the economic nature of their portfolios or the investors may be individuals who take the time to understand and evaluate their portfolios. With these factors in mind, the subcommittee has observed that individual investors are an important constituency of the investment community. Individual investors have, generally, both less time availability and access to primary and secondary analysis tools than do institutional investors, thus raising the time commitment they need to do comparable analyses of company filings. A large portion of individual investors have lower levels of financial sophistication and respond to complicated documents by simply not reading them.

Subcommittee #4 has been exploring the use of a management letter to shareholders or other summary report as a mechanism for a reporting company to provide summary information to investors and shareholders about its business, financial condition, and other material information annually, quarterly, and at more frequent intervals. The subcommittee believes that companies should be encouraged to provide relatively short, plain English shareholder summary letters to investors that would help investors fundamentally understand the companies’ businesses and activities. Such a summary report would be geared toward the retail investor and would be in

⁶ The subcommittee 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 subcommittee viewed information delivery relating to ongoing company reporting by public companies as the area needing greater focus.

addition to the annual report to shareholders currently required under the federal proxy rules and the periodic reports filed with the SEC. The subcommittee contemplates that the summary report would be available to the public on a company's website and also may be provided to shareholders directly.

The subcommittee has not explored in detail the content of a summary report, but, at a minimum, such a summary report could summarize key information that is discussed in greater detail in a company's periodic reports filed under the Exchange Act or in a company's glossy annual report. Such a summary report also could contain additional information about a company and its financial condition and results of operations. Members of the subcommittee believe that the summary report would be most useful if it included high-level summaries across a broad range of key components of the underlying report or release, rather than detailed discussion of a limited number of variables. The summary report would not replicate a company's glossy annual report. For a summary of a company's annual report, among the items that subcommittee members noted that investors may want to see in a summary report include some or all of the following:

1. A letter from the CEO/Chairman;
2. Brief description of the company's business, sales and marketing;
3. A digest of the company's GAAP and non-GAAP key performance indicators (KPI's);
4. 10 year summary financial figures;
5. Summary of a company's current financial statements;
6. MD&A, including a list of the company's subsidiaries and brands discussions, as well as a summary of risk factors.

Interim summary reports could be used to provide updated information based on information contained in a company's Forms 10-Q or other public information releases. The subcommittee would expect such summary interim reports to be relatively short.

The subcommittee discussed the fact that a summary report should present information in a manner that emphasizes, within the universe of material information that is disclosed, the information and analysis that is most important to a company. The subcommittee views the summary report approach as an efficient way to provide retail investors a concise overview of a company, its business, and its financial condition. For the more sophisticated investor, the subcommittee believes that the summary report may be helpful in presenting the company's unique story which the sophisticated investor could consider as it engages in a more detailed analysis of the company, its business and financial condition.

The subcommittee believes that consideration of the treatment of the summary report under the federal securities laws is important. The subcommittee noted that issues to consider include whether the summary report would be required to be filed with or furnished to the SEC, and what liability reporting companies would have for the content of their summary reports. The subcommittee discussed ways in which reporting companies could use such summary reports and address concerns about increased liability under the antifraud provisions of the federal securities laws. In addition, to encourage the use of summary reports by reporting companies, the subcommittee believes that it is appropriate to permit the summary reports, without additional liability, to:

- ◆ reference previously filed company reports under the Exchange Act;
- ◆ include hyperlinks to such filed Exchange Act reports or other additional information about a company so that investors easily can obtain additional or more detailed information about the matters discussed in the summary report;
- ◆ be provided at or after the Exchange Act periodic report or earnings release on which it may be based has been filed with or furnished to the SEC;
- ◆ to aid accessibility, be available electronically to the public on a reporting company's website without being required to be filed with or furnished to the SEC; and
- ◆ not be considered a "solicitation" under the federal proxy rules if it is regularly released in the ordinary course.

Based on the above considerations, the subcommittee intends to finalize the following preliminary hypotheses for the January 2008 full committee meeting:

Underlying principle: Increase the usefulness of company reports to individual shareholders without raising either the cost to produce or the legal exposure for issuers.

Preliminary Hypotheses:

The SEC should confirm the ability of reporting companies to publicly provide summary reports of their periodic or current Exchange Act reports or other ongoing information releases provided to the public.

Such summary reports should be able to reference the filed, furnished, or other publicly available report or release on which the summary is based and provide active hyperlinks to such reports and additional information. Such references or hyperlinks should not affect a reporting company's liability under the federal securities laws and statements in the summary reports should be able to be evaluated in light of the reports or information that have been referenced.

Such summary reports should not be considered "solicitations" under the federal proxy rules if they are regularly released by the reporting company in the ordinary course.

Questions for the Full Committee:

Does the full committee agree with the subcommittee's preliminary hypotheses regarding summary reports? What revisions, if any, would the full committee suggest?

Use of Interactive Data (XBRL)

The subcommittee has been examining the use of XBRL by public reporting companies. 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 application can go into the SEC's database, extract the sales numbers and download them directly to a spreadsheet. This process takes 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 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 database with the appropriate search application. The numbers would again 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.

The SEC has adopted a voluntary pilot program for use of XBRL. 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 both a U.S. GAAP taxonomy developed by XBRL-US and a risk and return taxonomy developed by the Investment Company Institute.

The subcommittee has met with representatives of various constituencies of the financial reporting process regarding the use of XBRL and intends to approach additional market representatives regarding issues relating to the use of XBRL under the Exchange Act reporting regime.

The subcommittee believes, in conformity with the unanimous opinion of both preparers and users we consulted, that interactive data under an XBRL platform will offer significant benefits to public company preparers, users of public company reports, and the financial markets generally. Although the subcommittee recognizes that there are certain challenges to full implementation of XBRL, it believes that these can be effectively addressed. Accordingly, the subcommittee has concluded that 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 subcommittee sees the following potential benefits for reporting companies and users of financial and non-financial information:

- 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 data⁷
 - 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
 - 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

⁷ 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.

- Significant time and cost savings if integration is accomplished
- 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
 - Allows analysts to cover more companies because of reduced cost of coverage
 - 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

The subcommittee recognizes that there may be practical and policy issues associated with full mandatory implementation of an XBRL data reporting scheme. The subcommittee has identified these primary topics:

- Limited acceptance or understanding of XBRL
 - Companies, analysts, and software developers are generally unaware or uninformed about XBRL

- Company officers do not understand how it works or the improvements it would bring to both their financial reporting and their costs of reporting
- Company officers believe, incorrectly, that it would be expensive to implement; the two preparers we consulted cited 80 to 100 hours to prepare their first report
- Companies need greater certainty that XBRL will be adopted before they will expend the necessary resources to understand it and its benefits
- Implementation issues (including continuing education)
 - The taxonomies that XBRL-US intends to release for public review and testing in December, and as adjusted thereafter, will have to be comprehensive for each business sector, including all common reporting concepts
 - There will have to be a continuing and sustainable process that will maintain the alignment of XBRL taxonomies with market and reporting changes
 - Taxonomy
 - The new taxonomy has over 15,000 elements. This is true, but not relevant; XBRL is, first, a dictionary of terms. In order to be useful, it must contain all of the terms or concepts commonly used in GAAP financial statements. Because XBRL also is structured as a taxonomy, with its elements grouped in logical categories, it is not complex or difficult to navigate
 - Testing of taxonomies. The testing process, which is to determine that disclosures are complete and relevant in current market environment, is now underway; the subcommittee understands that the tested taxonomies will be released by XBRL-US for public review and user testing in early December, and public comment and user testing will further test the quality of the taxonomies
 - Need for continuing preparer guidance on use and development of XBRL taxonomies to ensure consistency and comparability, including to assure consistency of extension elements (tags)
 - Effects of extension elements in SEC filings on comparability – customized extensibility enables a company to tell its own unique story but may affect comparability. This is an inherent tension in the system, and one of the things that preparer guidance will need to address on a continuing basis
 - Application of XBRL to footnotes and non-financial statement disclosures such as MD&A will require additional work and guidance by XBRL specialists
 - Need to consider financial statements of foreign or other issuers that are not prepared using U.S. GAAP. IFRS taxonomies are currently being recast into US GAAP architecture to promote convergence
 - The special challenges and burdens faced by smaller public companies
- Reliability/accuracy and assurance issues. The subcommittee believes that the following are the key issues that have to be resolved on the assurance question. The subcommittee believes that it is important that audit procedures for assurance on XBRL documents not add materially to audit expense.
 - Accuracy of “tagging”

- Appropriate taxonomies used to describe reported concepts. E.g. did a bank use the banking taxonomy where appropriate or did they use the software taxonomy?
 - Appropriate application of XBRL taxonomy elements to individual company disclosures. Did management apply the sales taxonomy concept to the sales disclosure or did they apply it to shares outstanding?
 - Conformity with best practices as to the how granular disclosures should be structured using taxonomy concepts. How deep into the reported concepts is it appropriate for issuers to tag, and how far do the investors and analysts want them to tag?
 - Appropriateness of label/reference overrides. E.g., the disclosure item is 'Sales' and the common presentation label is 'Sales' but the company overrides the common presentation label and makes it 'Earning per share' However, if the company overrides the common presentation label and makes it 'Revenue' then is it acceptable?
 - Proper relationships within and between disclosure concepts. E.g., is the EBITDA supporting calculation in conformity with the reported concept?
 - Appropriate application of extensions for company specific reporting concepts. Are the extensions (tags) reasonable and consistently applied via the hierarchical structure?
 - Appropriate and consistent description of reports. Descriptions of the overall report document is more critical in an XBRL environment than in paper reporting, since the reports will be read by machines. E.g., if an investor sends a query for, say, the 'IBM statement of financial position' or the 'IBM balance sheet' he'll get it, but if the name has been changed to 'Period end summary' he won't.
- Issue of assurance that items are properly tagged without requiring duplicative audit procedures
 - Certification that the company report, taken as a whole, is fairly presented as well as the application of XBRL taxonomy elements to individual company disclosures. There is concern that investors may believe that assurance is provided at the level of individual disclosure item rather than on the company report 'taken as a whole'.
 - Consistent use of taxonomies. E.g., consistent application of taxonomies from period to period
- Costs of implementation and compliance
 - If mandated, preparers may use an add-on solution in-house or use a service provider in the early stages before moving to a broader integrated interactive data approach. These costs in the initial phase on the facing documents appear to be low
 - The full benefits of XBRL for companies will most likely come when they incorporate XBRL in their internal reporting, instead of using it as an "add-on" after the financial reports are prepared. The subcommittee understands that is why companies may see XBRL as involving two reports—one the paper report and the other the XBRL report. The subcommittee believes that support from the corporate reporting community for mandating the use of XBRL, will more readily occur if they recognize that very substantial savings will come from developing financial reports directly from internal processes. The subcommittee has observed that currently, the preparation of financial reports is an "add-on" to the

reporting of internal data on operations. With XBRL, the two can be integrated, so that financial reports are created directly.

- Tagging beyond financial statements, such as footnotes and non-financial data, may require significant effort
- Liability Concerns
 - Treatment of XBRL data as filed with or furnished to the SEC

Underlying principle: Implementing the use of XBRL by public reporting companies will provide significant future benefits to preparers, users, and the market

Preliminary Hypotheses

The SEC should consider mandating, or through other means create momentum for, wide scale adoption of XBRL within a defined time frame. The SEC should develop a roadmap that would phase-in compliance based on the size of the reporting company and the amount of information to be reported. The roadmap also would take into account issues involving technological developments and assurance. For example, as a first phase, the SEC should consider mandating the use of XBRL for the facing financial statements for fiscal years ending December 31, 2008 for large accelerated filers.

The SEC should work to reinforce the principles that XBRL be available without royalty, with a consistent global architecture, and accessible to the serious retail investor without the purchase expensive software.

The subcommittee believes that mandating the use of XBRL would accelerate the realization of long term benefits for:

- the preparer community
- investors and analysts
- auditors
- regulators

Accordingly, the subcommittee believes that the SEC should adopt a measured approach in implementing a mandated XBRL system, recognizing that there may be challenges associated with company size, technological developments, and cost. The subcommittee believes that the challenges to adoption of XBRL by reporting issuers can be overcome by the following and intends to evaluate these matters further before the January 2008 full committee meeting:

- Acceptance and implementation of XBRL
 - Require the use of XBRL through a phased-in approach
 - Condition mandatory implementation of XBRL on successful testing of the taxonomies and tagging technology
 - Assure flexibility and technical support to allow for changes in technology and accounting
- Reliability of tagged data

- Resolve the questions of auditor assurance
- Consider alternatives to auditor assurance
 - o Third-party verification structure
 - o Internal company verification/certification
 - o Development and use of self-checking software
- Liability for tagged data
 - Phase-in appropriate liability for tagged data
 - Retain auditor involvement and liability as today for filed audited financial statements
 - Consider future treatment of liability for tagged data once companies begin filing periodic and current reports with financial statements prepared on an integrated basis
- Early filers may move more quickly through the phases to help move up the learning curve

Questions for the Full Committee:

1. What views do the Committee members have on the benefits and challenges that the subcommittee has identified?
2. What additional suggestions do the Committee members have to address the identified challenges or other challenges the subcommittee has not noted?
3. What are the Committee's views on making XBRL mandatory or other ideas on achieving a belief in its wide scale adoption to clear the "wait and see" hurdle?
4. What are the Committee's views on the role that a company's auditors should have in a company's use of XBRL?

Current Status and Further Work

The subcommittee expects to finalize a recommendation to the full committee regarding the use of summary reports for the January 2008 full committee meeting. The subcommittee expects to continue discussions and develop preliminary recommendations to the full committee regarding XBRL, including assurance and phase-in issues as noted above, 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;
- Continue discussions regarding the use of press releases and websites for providing information to investors;
- Consider potential recommendations as to the consistent layout and related matters for regular communications such as a reporting company's quarterly earnings press release;
- Address how MD&A is reported;

- Continue discussions regarding enhanced business reporting including the disclosure of key performance indicators by reporting companies as well as the use by reporting companies of non-GAAP financial measures;
- Consider the need for the SEC to issue guidance regarding the reporting liabilities of preparers; and
- Consider whether an ongoing dialogue between preparers and users on the subject of communications should be encouraged through a neutral party.

Coordination with Other Subcommittees

The subcommittee has not identified any issues at this time to be referred to other subcommittees for consideration.

EXHIBIT F

Index of Written Statements Received

Listed below are the written statements received by the Advisory Committee between its first meeting on August 2, 2007 and its second meeting on November 2, 2007 and the dates of receipt.

Nov. 2, 2007	Dr. Robert A. Howell, Distinguished Visiting Professor or Business Administration at the Tuck School of Business at Dartmouth
Oct. 24, 2007	Enhanced Business Reporting Consortium
Oct. 13, 2007	Sherman L. Rosenfield, CPA, Miami, Florida
Oct. 13, 2007	Sherman L. Rosenfield, CPA, Miami, Florida
Oct. 11, 2007	Jeff Mahoney, Investors Technical Advisory Committee
Oct. 10, 2007	Kenneth E. Bentsen, Jr., President, Equipment Leasing and Finance Association
Oct. 8, 2007	Richard S. Furlin, EQ Metrics
Oct. 3, 2007	Allan Cohen, Financial Reporting Committee, Institute of Management Accountants, New York, New York
Oct. 3, 2007	Paul Hazen, CEO, National Cooperative Business Association, Washington, District of Columbia
Oct. 1, 2007	June M. Johnson, Chair of the AFP Financial Accounting and Investor Relations Task Force and Maureen O'Boyle, Chair of the AFP Government Relations Committee
Oct. 1, 2007	BDO Seidman, LLP
Sep. 28, 2007	David A. Lifson, President, New York State Society of Certified Public Accountants
Sep. 26, 2007	Michael J. Ryan, Jr., U.S. Chamber of Commerce, Washington, District of Columbia
Sep. 26, 2007	Arnold C. Hanish, Chair, Committee on Corporate Reporting, Financial Executives International
Sep. 25, 2007	Richard S. Furlin, President, EQ Metrics
Sep. 21, 2007	David B. Armon, Chief Operating Office, PR Newswire, New York, New York
Sep. 20, 2007	Keith Boocock, Chief Executive Officer, Canadian Public Accountability Board
Sep. 20, 2007	Cathy Baron Tamraz, President and Chief Executive Officer, Business Wire
Aug. 29, 2007	David Erwin, Fort Worth, Texas
Aug. 23, 2007	Chris Carvalho, Aloha, Oregon
Aug. 14, 2007	Edward W. Dodds, Strategist, Systems Architect, Conmergence, Nashville, Tennessee