

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

**February 14, 2008**



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

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**SEC ADVISORY COMMITTEE ON  
IMPROVEMENTS TO FINANCIAL REPORTING**

Washington, DC 20549

February 14, 2008

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

Dear Chairman Cox:

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

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

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

Conrad Hewitt  
John W. White  
James Daly  
Bert Fox  
Stephanie Hunsaker  
Nili Shah  
Brett Williams

James Kroeker  
Wayne Carnall  
Adam Brown  
Todd E. Hardiman  
Shelly Luisi  
Amy Starr

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

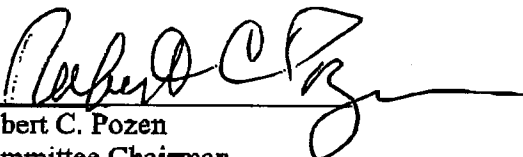
We also want to thank our Official Observers whose participation and counsel have been invaluable to the Committee during this time:

Robert Herz  
Kristen Jaconi  
Mark Olson

Charles Holm  
Phil Laskawy

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

Respectfully submitted on behalf of the Committee,



Robert C. Pozen  
Committee Chairman

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

## EXECUTIVE OVERVIEW<sup>1</sup>

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

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

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

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

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

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

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

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

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

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

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

## **I. Themes**

### **I.A. Investor Perspective**

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

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

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

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<sup>5</sup> We wish to emphasize that the examples we give are illustrative only. We do not mean to imply any order of priority.

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

### **I.B. Setting Standards and Interpretative Process**

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

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

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

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

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

### **I.C. Design of Standards**

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

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

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

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

### **I.D. Professional Judgment**

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

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

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

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

### **I.E. Global Convergence**

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

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

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

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

## **II. Summary of Developed Proposals**

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

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

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

2. GAAP should be based on a presumption that formally promulgated alternative accounting policies should not exist. The SEC should recommend that any new projects undertaken jointly or separately by the FASB not provide additional optionality, unless, in rare circumstances, it can be justified. Any new projects should include the elimination of existing alternative accounting policies in relevant areas as a specific objective of those projects, unless, in rare circumstances, the optionality can be justified. (Chapter 1 – developed proposal 1.2)
3. Additional investor representation on standards-setting bodies is central to improving financial reporting. Only if investor perspectives are properly considered by all

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

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

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

- Add investors to the FAF to give more weight to the views of different types of investors, both large and small
  - Give more representation on both the FASB and the FASB staff to experienced investors who regularly use financial statements to make investment decisions to ensure that standards-setting considers fully the usefulness of the resulting information. (Chapter 2 – developed proposal 2.1)
4. The SEC should assist the FAF with enhancing its governance of the FASB, as follows:
- By encouraging the FAF to develop performance metrics to assess the FASB’s adherence to the goals in its mission statement, objectives, and precepts and to improve its efficiency
  - By supporting the FAF’s changes outlined in its *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB*, with minor modifications regarding composition of the FAF and the FASB, as proposed in section II of chapter 2, and agenda-setting, as proposed in section IV of chapter 2
  - By encouraging the FAF to amend the FASB’s mission statement, stated objectives, and precepts to emphasize that an additional goal should be to minimize avoidable complexity. (Chapter 2 – developed proposal 2.2)
5. The SEC should encourage the FASB to further improve its standards-setting process and timeliness, as follows:
- Create a formal Agenda Advisory Group that includes strong representation from investors, the SEC, the PCAOB, and other constituents, such as preparers or auditors, to make recommendations for actively managing U.S. standards-setting priorities
  - Refine procedures for issuing new standards by: (1) implementing investor pre-reviews designed to assess perceived benefits to investors, (2) enhancing cost-benefit analyses, and (3) requiring improved field visits and field tests
  - Improve review processes for new standards by conducting post-adoption reviews of every significant new standard, generally within one to two years of its effective date, to address interpretive questions and reduce the diversity of practice in applying the standard, if needed
  - Improve processes to keep existing standards current and to reflect changes in the business environment by conducting periodic assessments of existing standards. (Chapter 2 – developed proposal 2.3)
6. The number of parties that either formally or informally interprets GAAP and the volume of interpretative implementation guidance should continue to be reduced. The SEC should coordinate with the FASB to clarify roles and responsibilities regarding the issuance of interpretive implementation guidance, as follows:

- The FASB Codification, a draft of which was released for verification on January 16, 2008, should be completed in a timely manner. In order to fully realize the benefits of the FASB’s codification efforts, the SEC should ensure that the literature it deems to be authoritative is integrated into the FASB Codification to the extent possible, or separately re-codified, as necessary.
  - To the extent practical, going forward, there should be a single standards-setter for all authoritative accounting standards and interpretive implementation guidance that are applicable to a particular set of accounting standards, such as GAAP or IFRS. For GAAP, the FASB should continue to serve this function. To that end, the SEC should only issue broadly applicable interpretive implementation guidance in limited situations (see section VI of chapter 2).
  - All other sources of interpretive implementation guidance should be considered non-authoritative and should not be required to be given more credence than any other non-authoritative sources that are evaluated using well-reasoned, documented professional judgments made in good faith. (Chapter 2 – developed proposal 2.4)
7. The FASB or the SEC, as appropriate, should issue guidance reinforcing the following concepts:
- Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor.
  - Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor.
  - Just as qualitative factors may lead to a conclusion that a quantitatively small error is material, qualitative factors also may lead to a conclusion that a quantitatively large error is not material. The evaluation of errors should be on a “sliding scale.”

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

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

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

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

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

- Materiality in interim period financial statements must be assessed based on the perspective of the reasonable investor
- When there is a material error in an interim period, the guidance on how to correct that error should be consistent with the principles outlined in developed proposal 8 above. (Chapter 3 – developed proposal 3.3)

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

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

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

- The largest 500 domestic public reporting companies based on unaffiliated market capitalization (public float) should be required to furnish to the SEC, as is the case in the voluntary program today, a document prepared separately from the reporting companies' financial statements that are filed as part of their periodic Exchange Act reports. This document would contain the following:
  - XBRL-tagged face of the financial statements<sup>9</sup>
  - Block-tagged footnotes to the financial statements.<sup>10</sup>
- Domestic large accelerated filers (as defined in SEC rules, which would include the initial 500 domestic public reporting companies) should be added to the category of companies, beginning one year after the start of the first phase, required to furnish XBRL-tagged financial statements to the SEC.
- Once the preconditions noted above have been satisfied and the second phase-in period has been implemented, the SEC should evaluate whether and when to move from furnishing to the SEC to the official filing of XBRL-tagged financial statements with the SEC for the domestic large accelerated filers, as well as the inclusion of all other reporting companies, as part of a company's Exchange Act periodic reports. (Chapter 4 – developed proposal 4.1)<sup>11</sup>

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

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

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

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<sup>9</sup> To allow this first phase, the SEC EDGAR system must permit submissions using the new XBRL U.S. GAAP Taxonomy.

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

<sup>11</sup> A dissenting vote on developed proposal 4.1 was cast by Peter Wallison.

# INTRODUCTION<sup>12</sup>

## **I. Our Objective**

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

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

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

## **II. Our Guiding Principles**

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

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

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

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

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

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

### **Definition of Complexity**

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

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

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

### **Causes of Complexity**

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

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

- The existence of opposing points of view that were taken into account when developing standards – most importantly, the attempts by public companies to smooth amounts that vary from period to period, versus the requests from those who want such amounts marked to market each period.
  - The challenge of describing accounting principles in simple terms (i.e., plain English) for highly sophisticated transactions
  - The presence of detailed guidance for numerous specific fact patterns
  - The impact of multiple bodies setting standards
  - The development of such standards on the basis of an incomplete and inconsistent conceptual framework.
4. Volume – The vast number of formal and informal accounting standards, regulations, and interpretations, including redundant requirements, make finding the appropriate standard or interpretation challenging for particular fact patterns.
  5. Audit and regulatory systems that challenge the use of professional judgment – The risk of litigation and the fear of being “second-guessed” results in (1) a greater demand for detailed rules on how to apply accounting standards to an ever increasing set of specific situations, (2) unnecessary restatements that are not meaningful to investors, and (3) legalistic disclosures that are difficult to understand.
  6. Educational shortcomings – Undergraduate and graduate education in accounting has traditionally emphasized the mechanics of double-entry bookkeeping, which favors the use of detailed rules rather than the full understanding of relevant principles. The same approach is evident in the certified public accountant exam, as well as continuing professional education requirements.
  7. Information delivery – The need for information varies by investor type and is often driven by a legal, rather than an investor, perspective. In addition, the amount and timing of information, as well as the method by which it is transmitted, may result in complex and hard-to-navigate disclosures that cause investors to sort through material that they may not find relevant in order to identify pieces that are. These factors make it difficult to distinguish the sustaining elements of an entity from non-operating or other influences.

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

### **III. Our Scope**

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

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

#### **IV. Our Approach**

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

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

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

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

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

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

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

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

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

## CHAPTER 1: SUBSTANTIVE COMPLEXITY

### **I. Introduction**

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

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

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

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

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

<sup>18</sup> Hedge accounting guidance is provided in SFAS No. 133, *Accounting for Derivatives and Hedging Activities*.

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

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

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

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

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

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

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

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<sup>19</sup> See discussion of bright lines below for further details.

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

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

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

## **Background**

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

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

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

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

<sup>22</sup> Refer to appendix B for additional examples.

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

The proliferation of specialized industry standards creates two problems that can hinder standard setters’ efforts to issue subsequent standards using a more objectives-oriented regime:

- The existence of specialized industry practices may make it more difficult for standard setters to eliminate scope exceptions in subsequent standards (e.g., many standards contain exceptions for insurance arrangements subject to specialized industry accounting)
- The specialized standards may create conflicting GAAP, which makes it more difficult for accounting professionals to determine the appropriate accounting.

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

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

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

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

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

<sup>25</sup> SAB Topic 13.

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

### **Discussion**

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

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

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

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

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

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

## **II.B. Alternative Accounting Policies**

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

### **Background**

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

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

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<sup>27</sup> For example, companies are free to choose from among several depreciation methods – straight-line, double-declining balance, etc.

<sup>28</sup> Refer to appendix B for additional examples.

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

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

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

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

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

### **Management Intent**

Some alternative accounting policies are based on management intent.<sup>30</sup> Management intent is a present assertion about management’s plans for future courses of action.<sup>31</sup>

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

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

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

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

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

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

### **Discussion**

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

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

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

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

### **III. Bright Lines**

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

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

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

- *Additional disclosure – We recognize that proportionate recognition is not universally applicable. In those cases, enhanced disclosure may be more appropriate. We have yet to define the possible scope of proportionate recognition and/or enhanced disclosure, but it may extend to areas such as leases, consolidation policy and off-balance sheet activity.*
- *Rules-of-thumb or presumptions, both coupled with additional considerations – We use rule-of-thumb and presumption to describe a method by which an accounting conclusion may be initially favored, subject to the consideration of additional factors. These are less stringent than bright lines, and may be appropriate where proportionate recognition may not apply.*

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

## **Background**

Bright lines refer to two main areas: quantified thresholds and pass/fail tests.<sup>33</sup>

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

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

<sup>33</sup> Refer to appendix B for additional examples other than those discussed in this section.

two quantitative tests,<sup>34</sup> where a mere 1% difference in the results of the quantitative tests leads to very different accounting.

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

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

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

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

<sup>35</sup> FASB Interpretation No. (FIN) 46 (revised December 2003), *Consolidation of Variable Interest Entities (FIN 46R)*.

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

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

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

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

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

### **Discussion**

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

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

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

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

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

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

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

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

<sup>38</sup> *Accounting for Derivatives and Hedging Activities.*

<sup>39</sup> *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

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

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

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

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

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

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<sup>40</sup> We acknowledge uncertainty also exists in other measurement attributes, such as historic cost, which may warrant similar disclosure.

## **Background**

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

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

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

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

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

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

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

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

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

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

## **Discussion**

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

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

## **V. Future Considerations**

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

### **Scope Exceptions in GAAP other than Industry-Specific Guidance**<sup>41</sup>

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

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

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

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

### **Competing Models**

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

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

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

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

## CHAPTER 2: STANDARDS-SETTING PROCESS

### **I. Introduction**

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

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

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

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

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

### **II. Investor Representation**

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

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

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

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

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

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

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

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

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

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

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

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

### **III. FAF and FASB Governance**

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

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

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

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

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

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

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

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

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

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

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

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

#### **IV. Standards-Setting Process Improvements**

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

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

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

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

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

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

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

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

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

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

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

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













































































































**EXAMPLES OF SUBSTANTIVE COMPLEXITY**

**1. Industry-Specific Guidance**

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

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

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

2. Industry-specific exceptions in GAAP, such as the scope exception for registered investment companies and life insurance entities in FIN 46R, *Consolidation of Variable Interest Entities* and for U.S. savings and loan associations, other “qualified” thrift lenders, and stock life insurance companies in SFAS No. 109, *Accounting for Income Taxes*.
3. Industry practice such as accounting for certain types of inventory at fair value















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