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In This Issue:

- Highlights of Final Report
- What Is CIFIr?
- Next Steps
- Appendix A: Summary of Significant Recommendations
- Appendix B: CIFIr Members and Observers

Complexity DeCIFIred

SEC Advisory Committee Releases Final Report

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The SEC Advisory Committee on Improvements to Financial Reporting (the “Committee” or CIFIr) has issued its [final report](#) to the SEC chairman and other SEC commissioners. The report contains 25 recommendations that, if implemented, CIFIr believes will “increase the usefulness of financial information to investors, while reducing the complexity of the financial reporting system to investors, preparers, and auditors.”

Highlights of Final Report

CIFIr’s research has been broad, and its recommendations cover a variety of processes that affect U.S. public companies (e.g., standard-setting, regulatory oversight, and delivery of financial information). The key themes underlying the Committee’s recommendations in its final report include the following:

- “Increasing the usefulness of information in SEC reports
- Enhancing the accounting standards-setting process
- Improving the substantive design of new accounting standards
- Delineating authoritative interpretive guidance
- Clarifying guidance on financial restatements and accounting judgments.”

The following recommendations (each discussed further in [Appendix A](#)), if implemented, are likely to result in significant and immediate change to the financial reporting system:

- Increase investor input in standards setting.
- Create a financial reporting forum (FRF).
- Conduct post-adoption effectiveness reviews of new FASB standards.
- Reduce the number of restatements by:
 - o Modifying how the materiality of an error is assessed.
 - o Changing how errors are corrected.
- Increase the exercise of professional judgment.
- Phase in the adoption of XBRL.¹
- Use executive summaries in annual and quarterly reports.

¹ eXtensible Business Reporting Language.

Editor's Note: The Committee acknowledged that significant international convergence efforts are currently underway and that full convergence could take years to achieve. Accordingly, the Committee decided to focus its attention on the current financial reporting system in the United States and noted that the principles underlying its recommendations are relevant regardless of the outcome of the convergence efforts.

What Is CIFIr?

The SEC formed CIFIr in July 2007 to independently review the current U.S. financial reporting system and provide the SEC chairman and other commissioners with detailed recommendations for its improvement. The goal? To reduce complexity in the current U.S. financial reporting environment and improve the usefulness of financial information for users and investors.

The SEC appointed Robert C. Pozen, chairman of MFS Investment Management, as CIFIr chairman, and designated 16 individuals from diverse backgrounds to represent investors, audit committees, preparers, auditors, and others with key roles in the securities markets. Five other representatives from the FASB, PCAOB, Department of the Treasury, IASCF,² and federal banking regulators served as official observers of the Committee's proceedings. See [Appendix B](#) for a list of all CIFIr members and official observers and their biographies.

Members were assigned to one of four subcommittees, with the CIFIr chairman serving as an ex officio member of all subcommittees:

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

Editor's Note: James H. Quigley, chief executive officer of Deloitte Touche Tohmatsu, was a member of the Standards-Setting Process subcommittee.

Throughout the year-long process, the Committee has maintained open due process and reached out to a variety of constituents. For example, panelists from diverse backgrounds were invited to testify at several of the open meetings held in different locations across the country. In addition, in February 2008 the Committee released a [progress report](#) encouraging readers to submit [comments](#) on the preliminary recommendations contained therein. (See Deloitte's [February 19, 2008, Heads Up](#) on the progress report.) The comment letters received and remarks made by panelists at open meetings were considered by Committee members in finalizing the 25 recommendations in the final report.

Committee meeting handouts, minutes, and other materials are all available on the [SEC's Web site](#).

Next Steps

Implementation of CIFIr's recommendations does not require legislative action — the SEC has already moved forward on some and is expected to act on others in the near future. The FASB and PCAOB are also expected to study the Committee's report and act on its proposals soon. Stay tuned.

The comment letters received and remarks made by panelists at open meetings were considered by Committee members in finalizing the 25 recommendations in the final report.

² International Accounting Standards Committee Foundation.

Appendix A: Summary of Significant Recommendations

The Committee's final report contains 25 recommendations that have resulted from its extensive work over the past year. Some of these, as summarized below, are likely to result in significant and immediate changes to the financial reporting system if they are implemented.

Increase Investor Input in Standards Setting

The Committee believes that since investors are the primary consumers of financial reports, their perspectives are critical to effective standard setting. To ensure that investors' voices are heard, the Committee recommends the following:

- Adding experienced investors who are knowledgeable about accounting concepts to the Financial Accounting Foundation (FAF), FASB, and FASB staff.
- Reevaluating current advisory group structures to ensure the effectiveness and efficiency of investor involvement.
- Reconstituting the User Advisory Council (UAC) to serve as a panel of investors who would review proposed standards and obtain feedback on perceived investor benefits or proposed alternatives or less costly solutions.

Create a Financial Reporting Forum

CIFiR recommends the formation of a financial reporting forum (FRF), which would consist of key constituents of the financial reporting community, including preparers, auditors, and investors. As proposed, the FRF would have regularly scheduled meetings and, when necessary, special meetings on short notice. These meetings would include the discussion of issues with key representatives from the SEC, FASB, and PCAOB. Although its decisions would be nonbinding, the FRF is expected to address issues related not only to the FASB, but to financial reporting and other system-wide priorities. The other main objectives of the FRF would be to:

- Recommend how to handle urgent matters and longer-term needs.
- Coordinate the issuance of new guidance.

Conduct Post-adoption Effectiveness Reviews of New FASB Standards

The Committee recommends that the FASB establish a formal process for performing post-adoption effectiveness reviews of new accounting standards within a reasonable period after a standard's effective date. During the post-adoption review period, the FASB would evaluate whether companies are applying new accounting standards in a manner consistent with the Board's original intent. The FASB would also evaluate diversity in practice and whether further implementation guidance is necessary.

According to CIFiR, during the post-adoption review period the SEC should allow for more than one interpretation when there are gaps or ambiguities in the new standard. The proposal does not provide a safe harbor; a preparer would need to demonstrate that the accounting interpretation was reasonable, supportable, and made in good faith. The Committee expects that the SEC would continue to respond to clear violations of the principles of new standards.

Reduce the Number of Restatements

Restatements have increased significantly over the past several years, with approximately one-third related solely to interim-filed financial statements. According to the Committee, many of these restatements are not important to investors, and the SEC should make efforts to reduce the number of amended filings. As detailed below, the Committee made several recommendations intended to either directly or indirectly "reduce the number of restatements that do not provide important information to investors."

Materiality of an Error

The Committee recommends that the FASB or SEC, as appropriate, supplement existing materiality guidance by clarifying how errors are evaluated on both an interim and annual basis. Specifically, errors should be evaluated on the basis of how they affect the “total mix of information available to a reasonable investor.” In addition, CIFIr believes that qualitative factors should be evaluated in the assessment of the materiality of an error, regardless of the quantitative size of the error. Under the current materiality guidance, qualitative factors may lead to a small error being deemed material, but a quantitatively large error not being deemed immaterial. Therefore, CIFIr recommends that the materiality guidance be supplemented to allow for a conclusion that because of qualitative factors a large error may not be material.

Editor’s Note: In [prepared remarks](#) at the “SEC Speaks in 2008” program of the Practising Law Institute, SEC Commissioner Paul S. Atkins supported the work performed by CIFIr in the area of materiality. Mr. Atkins suggested that the SEC intends to revisit the materiality guidance in SAB 99 and that he believes it should focus on the needs of a “reasonable investor.”

Correction of Errors

The Committee recommends that the FASB or SEC explore alternative methods that companies could use to correct and report errors. Again, the focus should be solely on the needs of a reasonable investor. CIFIr believes that the guidance on how to correct financial statements for errors should include the following:

- “[A]ll errors, excluding clearly insignificant errors,” should be promptly corrected, with no deferral to a future period.
- “Prior period financial statements should only be restated for errors that are material to those prior periods.” Materiality should be based on the needs of investors making current investment decisions. If errors are deemed not material to those prior periods, they may be corrected in the current period.
- Companies should be required to provide additional information after a restatement is announced, but before the amended financial statements are filed with the SEC (an interval commonly referred to as the “dark period”).

Increase the Exercise of Professional Judgment

The Committee notes that preparers and auditors are often hesitant to exercise professional judgment for fear that regulators will, after the fact, “second-guess” the reasonableness of the judgment made. CIFIr believes that the fear is a direct result of “a lack of clarity and transparency into the approach” that regulators use to evaluate the reasonableness of judgments made. To mitigate this concern, CIFIr recommends that the SEC and PCAOB each issue a “statement of policy” that articulates how it evaluates the reasonableness of judgments made and includes factors that it considers when making this assessment. The policy statement would most likely address areas in which professional judgments are often made, including:

- Selecting and applying accounting standards.
- Estimating amounts to record.
- Evaluating the sufficiency of evidence necessary to support professional judgments.

If implemented, the Committee’s recommendation would enable preparers and auditors to improve the quality of judgments made and increase the likelihood that the judgments would be accepted by the regulator. CIFIr has developed factors that the SEC and PCAOB should consider including in their respective policy statements, such as (1) performing a thorough analysis of the transaction and all relevant facts, circumstances, and accounting literature; (2) analyzing alternative views and practices; (3) documenting and explaining the rationale for the choice among alternatives selected; and (4) obtaining input from personnel with the appropriate levels of expertise.

CIFIr expects that adherence to the factors in the policy statement could result in a regulator accepting a range of alternative reasonable judgments for similar fact patterns. The policy statement, however, would not eliminate the ability of regulators to challenge judgments made and to enforce misapplications of GAAP.

Phase In the Adoption of XBRL

The SEC has been promoting the capabilities of XBRL (see Deloitte's [June 5, 2008](#), and [December 10, 2007](#), *Heads Ups*) for some time and appears to be headed toward mandatory adoption of XBRL in the future. Using XBRL, a financial statement preparer electronically tags financial and nonfinancial data in a standardized format, which greatly facilitates the ability of investors and analysts to receive customizable, high-quality data about companies' financial information.

The Committee recommends that XBRL filings be required in the future, but proposes a phased-in implementation approach. In phase one, the largest 500 domestic public companies would be required to submit XBRL filings. In phase two, which would begin one year after the start of phase one, all domestic large accelerated filers would be required to submit XBRL filings. Once both phases have been implemented, the SEC would perform a detailed assessment of them. Before implementing XBRL filing requirements for smaller public companies, the SEC must determine that the assessment proves that the benefits of XBRL outweigh its costs of implementation and ongoing maintenance.

Editor's Note: On May 30, 2008, the SEC issued a proposed rule on using interactive data to improve financial reporting. The proposed rule incorporated CIFI's recommendation to use a phased-in approach for the adoption of XBRL. The new rule would require domestic and foreign companies that prepare their financial statements in accordance with U.S. GAAP and IFRSs (as issued by the IASB) to use XBRL when submitting their financial information for periods ending on or after December 15, 2008, for the largest companies and within the following two years for smaller companies. Comments on the proposed rule were due by August 1, 2008. (See Deloitte's [June 5, 2008](#), *Heads Up* and Deloitte's XBRL FAQ document, "[Why You Need to Know About XBRL](#).")

Use of Executive Summaries in Annual and Quarterly Reports

The Committee notes that some investors may find it difficult to navigate through a company's publicly filed financial reports. Because of the sheer complexity and detail of the information provided, investors may simply ignore certain businesses or fail to understand the businesses that they actually invest in. CIFI therefore recommends that companies be required to provide a plain English executive summary for all quarterly and annual reports. The executive summary would cover the most important information about a company's business, financial condition, and operations.

Appendix B: CIFI Members and Observers

The information in this Appendix is reprinted from SEC Press Release No. 2007-154, issued on July 31, 2007.

Committee Chairman

Robert C. Pozen, Chairman, MFS Investment Management, which manages more than \$200 billion in assets for more than five million investors worldwide. Mr. Pozen also is an independent director of Medtronic and serves on the audit committees. Mr. Pozen was formerly vice chairman of Fidelity Investments, sponsor of the Fidelity funds. Prior to joining Fidelity, Mr. Pozen served as Associate General Counsel for the SEC. He will represent mutual funds.

Committee Members

Denny Beresford, Ernst & Young Executive Professor of Accounting, J.M. Tull School of Business, University of Georgia, Athens, Ga. Mr. Beresford is a member of the boards of directors and chairman of the audit committees of Fannie Mae, Kimberly-Clark Corporation and Legg Mason, Inc. He was the chairman of the Financial Accounting Standards Board from 1987 to 1997. Mr. Beresford will represent Fortune 500 audit committees.

Susan Bies, was a Federal Reserve Board Governor from 2001 to 2007. Before becoming a member of the Federal Reserve Board, Dr. Bies was Executive Vice President for Risk Management and Auditor at First Tennessee National Corporation in Memphis, Tenn. Dr. Bies will represent banking regulators.

J. Michael Cook, retired Chairman and Chief Executive Officer of Deloitte & Touche LLP. Mr. Cook is a member of the boards of directors and chairs the audit committees of Burt's Bees Inc., Comcast Corporation, and Eli Lilly and Company, and is a member of the board of directors and chairs the compensation committee of International Flavors and Fragrances. Mr. Cook will represent Fortune 500 audit committees.

Jeffrey J. Diermeier, President and Chief Executive Officer, CFA Institute, Charlottesville, Va. Prior to joining CFA Institute, Mr. Diermeier was global chief investment officer at UBS Global Asset Management. Mr. Diermeier will represent investment professionals.

Scott C. Evans, Executive Vice President, Asset Management, TIAA-CREF, New York, N.Y., and Chief Executive Officer of TIAA-CREF's investment advisory subsidiaries Teachers Advisors, Inc. and TIAA-CREF Investment Management LLC. Mr. Evans is responsible for development of TIAA-CREF's investment products and oversight of the company's more than \$380 billion in assets under management. Mr. Evans will represent pension funds.

Linda Griggs, Partner, Morgan Lewis, Washington, D.C. Ms. Griggs will represent securities attorneys.

Joseph A. Grundfest, William A. Franke Professor of Law and Business, Stanford Law School, Stanford, Calif., and co-director of the Rock Center on Corporate Governance at Stanford University. Mr. Grundfest joined Stanford's faculty in 1990 after serving for more than four years as an SEC Commissioner. Mr. Grundfest will represent securities attorneys.

Greg Jonas, Managing Director, Moody's Investors Service, New York, N.Y. Mr. Jonas joined Moody's from Andersen, where he led the technical functions that supported Andersen's worldwide financial assurance practice. In the 1990s, Mr. Jonas served as the Executive Director of the AICPA Special Committee on Financial Reporting. Mr. Jonas will represent credit rating agencies.

Christopher Liddell, Chief Financial Officer, Microsoft Corporation, Redmond, Wash. Mr. Liddell is responsible for leading Microsoft's worldwide finance organization and overseeing accounting and reporting, strategic planning and analysis, treasury, tax, audit and investor relations. Before joining Microsoft, Mr. Liddell was Chief Financial Officer of International Paper Co. Previously, he was Chief Executive Officer of Carter Holt Harvey Ltd., New Zealand's second-largest listed company. Mr. Liddell will represent Fortune 500 technology companies.

William H. Mann, III, Senior Investment Analyst, Motley Fool, Alexandria, Va., and the lead advisor for "Motley Fool Global Gains," an investment newsletter service focused on identifying market-beating international stocks. Mr. Mann will represent individual investors.

G. Edward McClammy, Senior Vice President, Chief Financial Officer and Treasurer, Varian, Inc., a global technology company in Palo Alto, Calif., that builds leading-edge tools and solutions for diverse, high-growth applications in life science and industry. Prior to joining Varian, Mr. McClammy served in various management roles at Quantum and Lucky Stores, Inc. Mr. McClammy also has worked for Price Waterhouse and the FASB. Mr. McClammy will represent mid-size companies.

Edward E. Nusbaum, Executive Partner and Chief Executive Officer, Grant Thornton, LLP, Chicago, Ill. Before becoming CEO, Mr. Nusbaum served as the firm's National Managing Partner of Professional Services, Managing Partner of the Philadelphia Office and National Director of Assurance Services based in New York. Mr. Nusbaum will represent auditors of mid-size and smaller public companies.

James H. Quigley, Chief Executive Officer, Deloitte Touche Tohmatsu, New York, N.Y. Mr. Quigley previously served as Chief Executive Officer of Deloitte & Touche USA LLP. Mr. Quigley will represent auditors of large and multi-national public companies.

David Sidwell, Former Chief Financial Officer, Morgan Stanley, New York, N.Y. Prior to joining Morgan Stanley, Mr. Sidwell spent nine years at PricewaterhouseCoopers and 20 years at JPMorgan Chase & Co. Mr. Sidwell will represent securities broker-dealers.

Peter J. Wallison, Senior Fellow, American Enterprise Institute for Public Policy Research, and co-director of AEI's program on Financial Market Deregulation. Before joining AEI, he practiced banking, corporate and financial law at Gibson, Dunn & Crutcher in Washington, D.C. Mr. Wallison also has served as General Counsel of the U.S. Department of the Treasury, General Counsel to the Depository Institutions Deregulation Committee, White House counsel to President Ronald Reagan and counsel to Vice President Nelson Rockefeller. Mr. Wallison will represent proponents of interactive data for financial reporting.

Thomas Weatherford, serves on the boards of directors of Synplicity Inc., Tesco Corporation, Advanced Analogic Technologies, SMART Modular Technologies, Mellanox Technologies and several private companies. Mr. Weatherford retired in January 2003 as Executive Vice President and Chief Financial Officer of Business Objects S.A. Mr. Weatherford will represent small and mid-size company audit committees.

Official Observers of the Committee

Robert Herz, Chairman, Financial Accounting Standards Board, Norwalk, Conn.

Charles Holm, Associate Director and Chief Accountant, Banking Supervision and Regulation, Federal Reserve Board.

Phil Laskawy, Chairman of the Trustees, International Accounting Standards Committee Foundation, which oversees the International Accounting Standards Board, London, U.K.

Mark Olson, Chairman, Public Company Accounting Oversight Board, Washington, D.C.

Kristen E. Jaconi, Senior Policy Advisor to the Under Secretary for Domestic Finance, U.S. Department of the Treasury.

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