ADVISORY COMMITTEE ON IMPROVEMENTS TO FINANCIAL REPORTING

DRAFT DECISION MEMO

January 11, 2008

CHAPTER 2: SUBSTANTIVE COMPLEXITY

I. Scope

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

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

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

Exceptions to general principles create complexity because they deviate from established standards that were developed in due process. In effect, users and preparers no longer speak a uniform language to communicate financial information; they must learn new dialects. Other constituents in that communication process are similarly impacted.

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

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

The remainder of this chapter discusses each of these areas and the manner in which they contribute to complexity in greater depth. It also contains developed proposals or conceptual approaches to reduce their effects. The sequence in which these areas are presented does not necessarily indicate their relative priority to one another. Rather, certain areas warrant additional research and deliberation before reasonable proposals can be fully developed, such as the mixed attribute model and more meaningful grouping of

CHAPTER 3: STANDARD-SETTING PROCESS

I. Scope

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

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

The Committee notes that certain of its proposals in this area may be partially or substantially addressed by actions recently taken or in the process of being taken by the FAF, the FASB and the SEC, which this chapter will acknowledge, where applicable.

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

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

II. Overview

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