

**SEC Advisory Committee on Improvements to Financial Reporting  
Subcommittee II: Standard Setting  
Report for Discussion at November 2, 2007 Full Committee Meeting**

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***Introduction***

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

This report summarizes the efforts of the Standard Setting subcommittee thus far and reflects only tentative thinking in each area. After receiving input from the full committee, the subcommittee intends to continue to seek input from various constituencies in the financial reporting community in preparation for full committee consideration of certain interim recommendations in January 2008.

***Members:***

David Sidwell, Chair  
Dennis Beresford  
Scott Evans  
James Quigley

***Observers:***

Robert Herz, FASB  
Mark Olson, PCAOB

***Scope of Work Plan***

The subcommittee has been tasked with examining the standard setting process in the U.S. in order to make recommendations for the full committee to consider to improve the quality of financial information delivered to investors and reduce undue complexity in the financial reporting system. The Discussion Paper recommended that the subcommittee evaluate the following:

- The U.S. GAAP hierarchy.
- Characteristics of the Financial Accounting Standards Board (FASB).
- The FASB standard setting process.
- Interpretive guidance from the Emerging Issues Task Force (EITF).
- Interpretive guidance from the SEC.
- Interpretive guidance from other sources.
- The use of cost-benefit analyses in standard setting and the review of the analyses performed for particular standards.

The subcommittee agreed that all of the topics in the Discussion Paper will be included within its scope but decided to organize its evaluation of each within the following broad categories:

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- Governance.
- Agenda and standard setting processes.
- Proliferation of accounting interpretations.
- Design of standards.
- International considerations.

Each category is described below, together with our related preliminary hypotheses concerning recommendations for the full committee designed to improve the quality of financial reporting and reduce undue complexity. The subcommittee acknowledges that certain of its proposals for how to improve the usefulness of the current financial reporting system may be partially or substantially addressed by actions recently taken or in the process of being taken by the FASB and SEC.

To finalize the scope of its work plan and obtain input on its preliminary hypotheses, the subcommittee intends to continue to seek input from various constituencies in the financial reporting community. In its future deliberations, the subcommittee will also reflect in its work the potential impact on the FASB's agenda associated with any recommendations from the full committee.

Questions for the Full Committee:

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

***Deliberations and Preliminary Hypotheses***

**OVERVIEW**

U.S. GAAP has evolved over many years and its basic principles have become obfuscated by detailed rules, bright lines, exceptions and regulations, which reduces the transparency and usefulness of the resulting financial reporting. In addition, interpretative guidance proliferates from a variety of sources and becomes, intentionally or not, an additional source of GAAP that can add to the complexity in the financial reporting system, especially when there are conflicts between interpretations. The fear of being second-guessed sometimes causes auditors and preparers to ask for more rules and interpretations, which further exacerbate the problem. The FASB has taken recent actions intended to reduce the proliferation of formal interpretative guidance from different bodies, including establishing itself as the sole private-sector standard setter and interpretive body in the U.S. The FASB has also undertaken a significant project to develop a comprehensive, integrated codification of existing accounting literature

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organized by subject matter that would become an easily retrievable single source of GAAP, but the codification by itself will not resolve the root causes of complexity. The SEC is also a source of GAAP, including through non-authoritative processes such as comment letters and staff speeches that are perceived in the marketplace to be authoritative. In addition, informal interpretations continue to be issued by other bodies (e.g., the Center for Audit Quality), which also have the perception of being authoritative.

It is the opinion of the subcommittee that the fear of having good faith judgments be second-guessed significantly influences the behavior of participants in the financial reporting community and is a key driver of much of the undue complexity in the financial reporting system. If the full committee's recommendations have the ability to defuse the fear of second-guessing by replacing it with a willingness to respect reasonable, good faith judgments made following an agreed-upon professional judgment framework, the Advisory Committee will have met its mandate. Such a change in behavior would enable a simplification in the design of standards and would reduce the proliferation of interpretive guidance. Without such a change in behavior, meaningful improvements to financial reporting will be difficult.

In its deliberations of how the standard setting and interpretive processes in the U.S. may be improved, the subcommittee developed a number of preliminary hypotheses covering a broad spectrum of issues, many of which are inter-related. There are a few central issues that complement each other that the subcommittee would like to briefly highlight for the full committee, as follows:

1. Additional user involvement in the standard setting and regulatory processes is central to improving financial reporting. Only if user perspectives are properly considered will the output of the financial reporting process meet the needs of those for which it is intended. Additional user participation on the FAF and FASB, together with making FASB user advisory committees more effective, will help provide this perspective.
2. The SEC and FASB should work together to clarify roles and responsibilities in the standard setting and interpretive processes, which would reduce uncertainty in the financial reporting community. They should provide a roadmap of the standard setting and interpretive processes going forward that should clarify the following:
  - The FASB (and the EITF as its delegate) should be the primary issuer of broadly-applicable authoritative accounting guidance. The number of parties interpreting GAAP must be reduced by addressing the root causes of interpretations.
  - The SEC should issue registrant-specific accounting guidance and refer broadly-applicable issues to the FASB whenever possible.
  - When the SEC deems it appropriate to issue broadly-applicable authoritative accounting guidance, it should be done with appropriate due process to the extent

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- practicable. Furthermore, the SEC should implement internal procedures to ensure that all sources of accounting guidance emanating from various Divisions and Offices within the SEC are reviewed and approved by a single Chief Accountant.
- All other sources of accounting guidance should be considered non-authoritative and should not be given more credence than any other non-authoritative sources that are evaluated using well-reasoned, documented professional judgment. To accomplish this, the FASB's codification project should be completed in a timely manner to clarify which guidance is authoritative versus non-authoritative and to bring to the maximum extent practicable all of U.S. GAAP into a single location.
3. A formal process should be implemented to actively manage the priorities of the standard setting and interpretive processes in the U.S. that includes representation from the regulatory, standard setting, user, preparer, and auditor communities.
  4. The use of reasonable judgment should be further promoted in the way standards are both written and implemented, which would allow a reasonable amount of diversity in practice, as follows:
    - Accounting standards should be written in a manner that reflects the premise that there is trust and confidence in efficient markets through the respect of professional judgment, rather than by attempting to prevent abuse. They should not strive to answer every question and close every loop-hole, but rather, should be written with clearly-stated objectives and principles that may be applied to broad categories of transactions.
    - Standard setters should provide extended implementation periods for all new standards, which may allow the SEC to regulate compliance with new standards without forcing unwarranted restatements as long as the requirements in GAAP are followed.
    - Formal post-adoption effectiveness reviews of new standards should be conducted within 2-3 years of implementation. By identifying divergence that developed during the implementation period that is perceived to be too great, the standard setters may take corrective action to reduce diversity through the authoritative amendment process, with appropriate transition provided to avoid unwarranted restatements.

The subcommittee believes that an appreciation of the complementary nature of the preliminary hypotheses above would provide insight into the importance of the same preliminary hypotheses described more fully, but individually, below.

### **GOVERNANCE**

The subcommittee considered the potential ways in which (1) the SEC's delegation of standard setting authority to the FASB, and (2) the governance structure provided by the

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Financial Accounting Foundation (FAF) may be improved. The subcommittee believes that the SEC's delegation of standard setting to the FASB with oversight from the FAF (1) is appropriate, (2) is functioning as designed, and (3) does not contribute to complexity in a meaningful way. However, the subcommittee does have preliminary hypotheses regarding how the SEC and FASB should clarify roles and responsibilities going forward that will reduce uncertainty in the marketplace (see Preliminary Hypotheses 14-19).

*Preliminary Hypothesis 1: The standard setting and regulatory processes need more individual user perspectives, which may be accomplished with more user representation, especially on both the FAF and the FASB.* The subcommittee recognizes that user involvement is central to the issue of improved financial reporting, yet the intricacy of certain accounting matters and the complexity of the debate makes it difficult to attract individual users to participate in the standard setting and regulatory processes, which in turn reduces the perceived usefulness of financial statements themselves. However, it is important to strike an appropriate balance between the perspectives of users, preparers, and auditors. The subcommittee believes that the objective in the near-term should be to improve that balance by increasing consideration of the users' perspectives in the process, so that what results is an end product that meets the needs of those for which it is intended.

Future Considerations: The subcommittee will consider the role of sponsoring organizations in influencing the composition of the FAF, although the subcommittee recognizes that the sponsoring organizations currently serve in a vital nominating capacity. The subcommittee will also further consider whether and how individual FASB members represent particular constituencies and whether changes should be recommended that would increase their user focus. The subcommittee also plans to reflect on the preliminary findings of an external review of the FASB being sponsored by the FAF to determine if additional analysis of broad governance issues is justified.

Questions for the Full Committee:

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

**AGENDA AND STANDARD SETTING PROCESSES**

Due Process: The FASB's activities are open to public participation and observation as part of its due process procedures and the FASB actively solicits the views of its various constituencies on accounting issues. This process was designed to provide constituents with significant input into the decisions of the Board. The subcommittee believes that the

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FASB's approach to obtaining significant input through due process is fitting, although the subcommittee recognizes the difficult trade-off between due process and expediency. Therefore, the subcommittee is considering a number of additional preliminary hypotheses, as described below, to further enhance the standard setting process in the U.S. and improve its timeliness.

Agenda: Critics in the financial reporting community argue that the standard setting process in the U.S. is slow and they point to projects that have been on the Board's agenda for a number of years (e.g., the conceptual framework project, the revenue recognition project, the liabilities & equity project, etc.) to illustrate that there are fundamental standard setting issues that are routinely given a low priority. These critics also argue that standards that are issued are not always cohesive and may be based on several different principles. This may be due to the lack of a complete, current conceptual framework, competing priorities placed on the Board, and the evolutionary nature of standard setting in the U.S.

The FASB receives many requests for action on various financial accounting and reporting topics from all segments of its diverse constituency, including the SEC. The Board also turns to many other organizations and standing advisory committees for advice regarding its agenda, but these groups act solely in advisory capacities. There is no body that brings together the key stakeholders in the regulatory, standard setting, user, preparer, and auditor communities to actively manage priorities in the standard setting and interpretive processes. *Preliminary Hypothesis 2: A formal Agenda Committee that includes representation from the SEC, the FASB, users, preparers, and auditors should be created to provide advice on the standard setting agendas of the FASB, EITF, and SEC, while at the same time maintaining an appropriate focus on user needs. A framework should be developed that may assist the Agenda Committee with making agenda setting and prioritization decisions, including what projects to advise adding and removing from the agenda, and short-term priorities for active projects.* Future Considerations: The subcommittee will further explore (1) the structure of and representation on the Agenda Committee, including how to ensure that the SEC has a strong voice regarding the agenda (see Preliminary Hypothesis 17), (2) how to ensure that the scope of new projects is clear prior to commencing work, (3) whether to require a supermajority for adding projects to the FASB's agenda, which may encourage addressing only standard setting and interpretive issues with widely acknowledged needs, and (4) the impact of the existence of an Agenda Committee on the activities of various other FASB advisory groups.

*Preliminary Hypothesis 3: Although highly dependent upon the conclusions reached in International Considerations as described below, the subcommittee is exploring a recommendation for the full committee to consider that the FASB re-prioritize its existing agenda, which may include the following:*

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1. Consider the full committee's recommendations and the potential prioritization of those recommendations.
2. Finalize the codification of U.S. GAAP on a timely basis.
3. Continue efforts towards international convergence.
4. Complete the conceptual framework (jointly with the IASB).
5. As phase II of the codification project, consider whether GAAP should be systematically revisited, as follows:
  - To be more coherent post codification.
  - To remove redundancies.
  - To be less complex, where possible.
  - To be more principles-based.
  - To readdress frequent practice problems (as identified by restatement volumes, input from the SEC, recent interpretations, and frequently-asked questions).
  - To readdress outdated standards (i.e., sunseting).
6. Create a disclosure framework that may be used by the FASB in the future when assessing what types of disclosures are necessary based upon the type of information being conveyed.
7. Address emerging issues that urgently require attention (either directly or through the EITF as its delegate).

*Preliminary Hypothesis 4: In addition, the subcommittee may also recommend that the full committee consider recommending that the SEC work with the FASB to:*

1. Remove any redundancy between SEC disclosure requirements and other sources of GAAP.
2. Consider taking steps so that the SEC guidance to be included in the codification will conform to the extent possible with the rest of the format of the codification.
3. As phase II of the codification project, consider whether SEC literature should be systematically revisited and integrated with FASB guidance.

Conceptual Framework: The subcommittee believes that the completion of the conceptual framework, and a reconsideration of conflicts between the revised framework and U.S. GAAP, will be an important step to reduce inconsistencies in GAAP and improve the coherence of the reporting framework. Specifically, Board members should have such a framework that they may refer back to over time when standard setting to ensure cohesiveness and consistency in GAAP. The subcommittee acknowledges that many of the issues currently being addressed by the Board as part of the conceptual framework project are challenging and will have a pervasive impact on U.S. GAAP. Therefore, it will be important that constituents agree with the direction of the FASB and to do so, there may be opportunities during Board deliberations to further clarify what the specific impact of recommended changes to the conceptual framework will have on the full body of GAAP.

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Objectives: The subcommittee reflected on the FASB's published objectives and precepts for standard setting. The subcommittee plans to evaluate possible changes to the FASB's objectives and precepts that may provide guidance to the Board when balancing competing priorities in the future. *Preliminary Hypothesis 5: Two possible recommendations for the full committee to consider may be that (1) certain objectives should be given more emphasis, and (2) an objective should be added that accounting models should not introduce unnecessary complexity (i.e., not be more complex than the underlying transactions).*

Advisory Groups: As noted above in Preliminary Hypothesis 1, the subcommittee believes that there is a need for greater individual user involvement throughout the standard setting process. The FASB has a number of standing advisory groups and committees that it consults on technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces, and other matters. Future Considerations: The subcommittee is in the process of considering (1) whether the FASB makes effective use of its advisory groups, and (2) what other mechanisms may be effective in ensuring that sufficient input is received by appropriate parties and at the right time during the standard setting process. The subcommittee will also further consider how user involvement may be more effectively managed and made more transparent so that interested parties know when and how to engage the FASB and its staff to assist in standard setting.

Staffing: The subcommittee is also concerned that the organization and composition of its staff may constrain the FASB. *Preliminary Hypothesis 6: The FASB should consider an alternate staffing model that makes use of preparers, users, and auditors either directly or through task forces and resource groups (perhaps on a rotational basis) to bring additional subject matter expertise and recent business experience to each standard setting activity.* Such resources might be leveraged to do original thinking on new projects, assist in field testing, estimate the costs of implementing new standards, or serve as subject matter experts to the FASB's staff.

*Preliminary Hypothesis 7: The FASB's Major Projects and Technical Analysis & Interpretations groups should be combined and organized by subject matter expertise to:*

- *Ensure that major projects are led by subject matter experts.*
- *Ensure that interpretive issues are addressed by the same group involved in setting the standards.*
- *Facilitate inclusion of interpretive accounting guidance in the codified standards.*
- *Increase the interaction with relevant financial reporting constituents, resource groups, and alternate staff who have the same subject matter expertise.*

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Field Testing and Cost Benefit Analysis: The FASB evaluates whether the benefits of each new standard justify its costs by determining that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the perceived overall benefits. However, participants in the standard setting process have long acknowledged that reliable, quantitative cost-benefit calculations may seldom be possible, in large part because of the lack of available information on the costs and the difficulty in quantifying the benefits. Further, the magnitude of the benefits and costs are difficult to assess prior to preparers using the standard in the preparation of financial statements, auditors auditing that information, and users assessing the benefits of the resulting accounting and disclosure. *Preliminary Hypothesis 8: The subcommittee is considering a recommendation to the full committee that the FASB improve its procedures for field testing, field visits, and cost-benefit analyses, such that:*

- *Field tests and field visits should be required to be integrated into the standard setting process for all new standards.*
- *Cost-benefit analyses should be required to be performed as part of the field tests.*
- *This additional work should leverage the alternate staffing model described above. Specifically, the FASB should leverage work already being done by preparers, auditors, task forces, and user groups to assess the impact, operability, and auditability of proposed standards to help inform its views.*

The Discussion Paper proposed the review of previously-issued standards to understand cost-benefit analyses performed by the FASB, but the subcommittee decided that sufficient information regarding the efficacy of cost-benefit analyses may be obtained without performing a detailed review with reference to specific standards. Future Considerations: The subcommittee intends to also consider guidance from economists regarding whether there are other opportunities for the FASB to improve its cost-benefit analyses.

Fatal Flaw Reviews: *Preliminary Hypothesis 9: The review of near-final standards immediately prior to final release (sometimes referred to as fatal flaw reviews) should be more formalized.* Such a formalized review may identify unintended consequences of changes made since the previously-exposed drafts and may provide an additional opportunity for user involvement, given the near-final nature of the standard or interpretation. Currently, the IASB posts near-final exposure drafts to its website to facilitate such reviews by interested parties.

Post-Adoption Effectiveness Reviews: After a new accounting standard has been in place for multiple financial reporting cycles, more data may be available to evaluate its cost, efficacy, utility, and/or relevance in the current environment. However, currently the FASB does not have a process in place to do post-adoption effectiveness reviews of new standards. As a result, standards may miss important matters, not properly consider

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implementation issues, have unintended consequences, and as a result, may lose their relevance and effectiveness. As such, useful financial information might not be made available to the users of financial statements. *Preliminary Hypothesis 10: The FASB should conduct formal post-adoption effectiveness reviews of new standards within 2-3 years of implementation to:*

- *Ensure that the accounting that is being produced is what the FASB intended and is useful to readers of the financial statements.*
- *Re-assess the cost-benefit analyses.*
- *Deal with interpretive matters that arise.*
- *Ensure that only an acceptable amount of diversity in practice exists.*

As noted in Preliminary Hypotheses 3 and 4, *Preliminary Hypothesis 11: A review of all of U.S. GAAP should be performed periodically by the SEC and the FASB and should formally consider (1) restatement activity, (2) practice problems identified by the SEC, (3) the number of interpretations required since that last post-adoption effectiveness review, and (4) opportunities for simplification and sunseting.*

Promoting Reasonable Interpretations: The subcommittee also noted that one of the significant complexities of the current financial reporting and regulatory environment is that preparers, auditors, and other participants are sometimes penalized for improving their understanding and interpretations of accounting standards over time. This issue is especially problematic for new standards. *Preliminary Hypothesis 12: The FASB should provide 2-3 year extended implementation periods for all new standards prior to the first formal post-effectiveness review, during which time preparers may benefit from authoritative or non-authoritative implementation guidance to learn about how the standard is being interpreted and implemented without being forced to restate (except in egregious cases at the SEC's discretion in which the registrant clearly fails to apply the requirements of the standard). Such an extended implementation period would likely require the FASB to adopt standard transition guidance applicable to all new standards and may have the effect of allowing the SEC to satisfy its regulatory mandate of investor protection and capital formation in a more flexible manner.* This complements Preliminary Hypotheses 2, 10, 11, and 17. Issues arising during this process that are of an interpretive nature (other than clear violations of the standards, as determined by the SEC) would be re-considered by the FASB either during or at the end of the implementation period and authoritative amendments would be completed by the FASB to clarify the standard and reduce diversity in practice, as necessary.

The subcommittee does not mean to imply that it is considering recommending a move away from comparability in financial reporting; on the contrary, such post-adoption effectiveness reviews after an extended 2-3 year implementation period would actively manage comparability. By identifying divergence that developed during the implementation period that is perceived to be too great, the FASB may take corrective

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action to reduce diversity through the authoritative amendment process, with appropriate transition provided to avoid unwarranted restatements. Therefore, the subcommittee's preliminary thinking represents a shift in attitude away from the stark emphasis on comparability at any cost towards a careful evaluation of when diversity in practice becomes too great that it must be reigned-in. This is one reason why enhanced individual user involvement in Preliminary Hypothesis 1 is central to the subcommittee's other preliminary hypotheses.

Future Consideration: The subcommittee will further consider whether the standard implementation and transition guidance noted above should have a bias towards prospective or retrospective application.

Questions for the Full Committee:

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

**PROLIFERATION OF ACCOUNTING INTERPRETATIONS**

Codification: The subcommittee believes that there are too many sources of authoritative accounting guidance in U.S. GAAP. Interpretations of U.S. GAAP have proliferated over a number of years from a variety of sources. Often interpretive accounting guidance that is not formally authoritative is erroneously perceived by participants in the financial reporting and legal communities to be additional sources of authoritative GAAP. This adds to complexity in the financial reporting system, especially if there are conflicts between these accounting interpretations. With that in mind, the subcommittee is considering *Preliminary Hypothesis 13: The FASB's codification project should be completed in a timely manner so that the flattening of the GAAP hierarchy into authoritative and non-authoritative accounting guidance will be completed as quickly as practical. As part of the codification validation process, the SEC should ensure that all accounting guidance it deems to be authoritative is included in the codification to the extent practicable.* The completion of the codification project (which will (1) flatten the GAAP Hierarchy to two levels, and (2) clarify explicitly those sources that are authoritative and those that are not) is an important aspect of Preliminary Hypotheses 14-19.

Clarify Roles and Responsibilities: The subcommittee hypothesizes that certain changes that clarify how the SEC and FASB should interact will further improve financial reporting, as follows:

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- *Preliminary Hypothesis 14: Authoritative accounting guidance that is broadly applicable is best issued by a single, private-sector standard-setter (e.g., the FASB and the EITF as its delegate) such that the guidance may be immediately updated in the codified version of GAAP. This hypothesis is based upon the presumption that the SEC will continue to be judicious when determining when to issue its own guidance (see Preliminary Hypotheses 17-18).*
- *Preliminary Hypothesis 15: Authoritative accounting guidance that is applicable only to specific registrants should be given solely by the SEC and should not be required to be applied more broadly. This will require more formal coordination within the SEC, as noted below.*
- *Preliminary Hypothesis 16: All precedent-setting accounting guidance applicable either broadly or to specific registrants (e.g., staff interpretations, speeches, information posted to its website, etc.) should be reviewed and approved by a single Chief Accountant. This will help to ensure consistency in the accounting conclusions that drive regulatory actions taken by various Divisions and Offices within the SEC. In future deliberations, the subcommittee will also consider the impact of caveat language commonly included on SEC staff guidance stating that it is either non-authoritative or does not represent the views of the SEC on the perception in the marketplace that it is non-authoritative.*
- *Preliminary Hypothesis 17: The SEC and the FASB should establish a formalized mechanism in which the SEC may refer agenda topics to the FASB such that the FASB (or the EITF as its delegate) can deliberate and issue authoritative accounting guidance that is broadly applicable, thereby reducing the need for the SEC to do so. Such a process would leverage the Agenda Committee described above in Preliminary Hypothesis 2, and the post-adoption effectiveness reviews described above in Preliminary Hypotheses 10 and 11, but may also require an additional ongoing communication process, to be further considered by the subcommittee. This would have the effect of specific registrant matters that have broad applicability being formally referred from the SEC Division of Corporation Finance to the SEC Office of the Chief Accountant to the FASB. Such a formal, transparent feedback loop would identify and prioritize issues with broad applicability that require immediate, authoritative accounting guidance from the FASB (or the EITF as its delegate) directly in the codified version of GAAP.*
- There may continue to be instances, albeit rare, when the FASB and EITF are unwilling or ineffective at addressing practice issues raised by the SEC.  
*Preliminary Hypothesis 18: Any accounting guidance issued by the SEC that is broadly applicable should to the extent practicable be (1) subject to due process, including public comment, and (2) easily integrated into the GAAP codification.*

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Preliminary Hypotheses 8-12 would also apply to the SEC when issuing such standards or interpretations.

- *Preliminary Hypothesis 19: All non-authoritative accounting guidance (including that which has historically been communicated in industry guides, SEC speeches, accounting firm guidance, etc.) should be clarified to be non-authoritative (by virtue of the fact that it will not be included in the codification) and would therefore not have more credence than well-reasoned, documented conclusions based on other, potentially-conflicting non-authoritative accounting guidance applied using a professional judgment framework. Although the FASB codification initiative will help alleviate some of the proliferation of accounting interpretations by including only authoritative accounting guidance, making meaningful improvements in financial reporting will be difficult if non-authoritative accounting guidance continues to have the perception it has today of pseudo-authority in the marketplace.*

In summary, Preliminary Hypotheses 14-19 reflect the subcommittee's tentative thinking that roles and responsibilities in the standard setting process could be clarified in such a way as to reduce uncertainty in the financial reporting community by:

1. Flattening the GAAP Hierarchy.
2. Providing a roadmap of the standard setting process going forward that clarifies that:
  - The FASB (and the EITF as its delegate) should be the sole issuer of broadly-applicable authoritative accounting guidance.
  - The SEC should issue registrant-specific accounting guidance and refer broadly-applicable issues to the FASB whenever possible.
  - When the SEC deems it appropriate to issue broadly-applicable authoritative accounting guidance, it should be done with appropriate due process to the extent practicable.
  - All other sources of accounting guidance would be considered non-authoritative and need not be given any more credence than any other non-authoritative sources that are evaluated using well-reasoned, documented professional judgment.

The subcommittee does not intend for the SEC's authority to (1) oversee the private-sector standard setting body, (2) set standards, or (3) regulate the capital markets be usurped in any way. Rather, Preliminary Hypotheses 14-15 will improve the clarity around what standard setter should provide guidance and what that guidance should ideally include. The SEC will continue to have ultimate authority, but Preliminary Hypothesis 18 is based upon the presumption that the SEC will continue to be judicious when determining when to issue its own guidance. Preliminary Hypothesis 16 will enhance the consistency of accounting guidance provided by the SEC to reduce the

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instances of mixed messages being communicated in the marketplace. Preliminary Hypothesis 17 recommends that the SEC continue to improve its oversight of the FASB by implementing a formal, transparent feedback loop. And Preliminary Hypothesis 19 clarifies that non-authoritative guidance should not be used to force restatements when other reasonable views exist. Taken together, this would be a significant change in practice.

Further Considerations: The subcommittee will further consider how to make these preliminary hypotheses operational. In its future deliberations, the subcommittee will evaluate other root causes of the proliferation of accounting interpretations to identify whether there are other changes that are necessary in the regulatory environment to reduce the need for multiple parties to informally interpret GAAP.

Questions for the Full Committee:

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

**DESIGN OF STANDARDS**

Some participants in the financial reporting community believe that accounting standards do not clearly articulate the objectives and principles upon which they are based. The subcommittee believes the objectives and principles inherent in existing U.S. GAAP are obfuscated by detailed rules, examples, scope exceptions, safe harbors, cliffs, thresholds, and bright lines. This makes it difficult for preparers and auditors to apply the standard's underlying objectives and principles, causing difficulty and uncertainty in application, because rules cannot cover all possibilities and create additional risk that the appropriate rule is not identified and considered. This, in turn, may drive requests from preparers, auditors and regulators to answer every question in the form of more prescriptive rules, examples and additional guidance. The result is an accounting system that is overly complex, has little room for professional judgment, and can engender a check-the-box approach. As such, the subcommittee is considering Preliminary Hypothesis 20: *Accounting standards should be written in a manner that reflects the premise that there is trust and confidence in efficient markets through the respect of professional judgment, rather than by attempting to prevent abuse.*

Similarly, the FASB's codification project is progressing at a rapid pace, yet participants in the U.S. financial reporting community have not built consensus about what standards should look like. As part of its deliberations, the subcommittee is considering what an ideal accounting standard should look like and whether a framework should be created that the standard setter may refer back to over time to ensure that these ideals are

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maintained. Preliminary Hypothesis 21: *Characteristics for the potential framework that are being evaluated include that accounting standards should:*

- *Faithfully represent the economic consequences of transactions.*
- *Be decision-useful and promote transparency.*
- *Be consistent with the FASB's conceptual framework.*
- *Have an appropriately-defined scope that addresses a broad area of accounting.*
- *Be written clearly and concisely in plain language.*
- *Have an appropriate balance between principles, explanations, examples, and other guidance based on the complexity of the transactions.*
- *Minimize rules, exceptions to the scope and principles, safe harbors, cliffs, thresholds, and bright lines.*
- *Allow for the use of well-reasoned, documented professional judgment, where appropriate, with transparent disclosure.*

Future Consideration: Once the subcommittee's perspectives about the design of standards is more complete, the subcommittee will further consider the approach that should be taken to migrate the codified version of U.S. GAAP to this ideal.

Questions for the Full Committee:

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

**INTERNATIONAL CONSIDERATIONS**

Future Considerations: The subcommittee has deferred full discussion of international considerations until comments have been received and evaluated by the SEC on (1) the proposal to remove the U.S. GAAP reconciliation for foreign-private issuers reporting under IFRS as promulgated by the IASB, and (2) the concept release on the possibility of allowing domestic issuers to report under IFRS as promulgated by the IASB. The subcommittee believes that international considerations should be included within its scope, because:

- It would be difficult to address standard setting in the U.S. without discussing convergence matters, especially given that the FASB's agenda is heavily influenced by convergence efforts.
- Convergence matters have in the past created conflicts in the Board's priorities.
- Differences between U.S. GAAP and IFRS are an additional source of confusion.
- Allowing domestic issuers to report under IFRS as promulgated by the IASB would be a significant change from today's process.

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The subcommittee believes that many of the preliminary hypotheses contained herein are equally applicable to the International Accounting Standards Board (IASB), with minor modifications. Therefore, international considerations are already implicit in the subcommittee's deliberations. Nevertheless, the subcommittee will defer in-depth discussion of international considerations until 2008.

Questions for the Full Committee:

- 1) Does the full committee agree with the subcommittee's intention to defer deliberations of international considerations associated with standard setting until 2008?

***Current Status and Further Work***

The subcommittee will continue to meet on a frequent basis with a goal of finalizing certain of its preliminary hypotheses for full committee consideration in January 2008 and publication as interim recommendations. The subcommittee is also planning to obtain further input on its preliminary hypotheses from various constituents in the financial reporting community. As noted above, international considerations will impact these recommendations and will be further deliberated in early 2008.

***Coordination with Other Subcommittees***

The subcommittee wishes to refer to the Audit Process and Compliance subcommittee work regarding a framework for professional judgment.

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