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Record of Proceedings of

SEC ADVISORY COMMITTEE ON
IMPROVEMENTS TO FINANCIAL REPORTING
OPEN MEETING

Friday, January 11, 2008

9:30 a.m.- 3:08 p.m.

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

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COMMITTEE MEMBERS PRESENT

3

4 Robert C. Pozen, Committee Chairman

5 Dennis R. Beresford

6 J. Michael Cook

7 Jeffrey J. Diermeier

8 Scott C. Evans

9 Linda L. Griggs

10 Gregory J. Jonas

11 Christopher Liddell

12 William H. Mann, III

13 G. Edward McClammy

14 James H. Quigley

15 David H. Sidwell

16 Peter J. Wallison

17 Thomas Weatherford

18

19

COMMITTEE MEMBERS ABSENT

20 Susan Schmidt Bies

21 Joseph A. Grundfest

22 Edward E. Nusbaum

23

24

25

1 OFFICIAL OBSERVERS PRESENT

2 Robert Herz

3 Charles Holm

4 Mark Olson

5 Kristen E. Jaconi

6

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8 OFFICIAL OBSERVERS ABSENT

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10 Philip Laskawy

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1 SEC AND COMMITTEE STAFF PRESENT

2

3 Conrad Hewitt, SEC Chief Accountant

4 James Kroeker, SEC Deputy Chief Accountant

5 John W. White, SEC Director,

6 Division of Corporation Finance

7 Wayne Carnall, SEC Chief Accountant,

8 Division of Corporation Finance

9 Russell Golden, FASB Senior Advisor to the

10 Committee Chairman

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1 P R O C E E D I N G S

2 MR. KROEKER: We have a rather lengthy document
3 that is a draft decision memo that incorporates all of the
4 hard work of the subcommittees, and the purpose today is to
5 obviously go through that document.

6 With that, Bob, I'll turn it over to you.

7 I N T R O D U C T O R Y R E M A R K S

8 CHAIRMAN POZEN: Thank you. First of all, I want
9 to thank all the Committee members for the huge amount of
10 work that has been done. I feel very proud that we have been
11 able to in the first six months actually come to grips with a
12 lot of these issues.

13 As we know, the full report is not due until
14 August. There is a tremendous amount of work, a lot of good
15 thinking, and we have been able to distinguish those
16 "developed proposals" that are ready to go to the Commission
17 and to other regulators from the conceptual approaches, which
18 we are still working on.

19 I also want to thank Jim and Russ and all of the
20 members of the staff. I'm not going to go through them, but
21 they have really done a great job and we really appreciate
22 it.

23 Our attempt here will be to go through this report.
24 Since in the first public meeting, we went through
25 Subcommittee 1, 2, 3, 4, we are going to go backwards, 4,

1 3, 2, 1.

2 Our attempt will be to reach a consensus on the
3 particular recommendations that are made. We are going to
4 assume that people have read the document and therefore, we
5 are not going to sort of have the subcommittees present what
6 the problem is and general remarks, but really try to focus
7 on those proposals and have debate.

8 Then our methodology will be, assuming as I hope we
9 will, that we will reach consensus on all if not most of
10 these issues and we will then have a few weeks' drafting
11 sessions.

12 I have asked a few of the Committee members who
13 have shown themselves willing to give us edits
14 to work with us to put together a draft and turn
15 this into a report that could be published that was not so
16 geared to a technical level and a decision making level, and
17 would have a little broader audience.

18 We hope to get that out in early February for all
19 of you to look at. I think our tentative plan is to have a
20 phone meeting and a formal vote on February 11th in the
21 afternoon.

22 Is that correct, Jim?

23 MR. KROEKER: That is correct. It will be an open
24 meeting under FACA. We will have a dial-in, but if anyone
25 wanted to attend live, they will be able to.

1 CHAIRMAN POZEN: The subcommittees will continue to
2 do their work and we will still aim at having a final report
3 at the end of the Summer, but the idea here is to get as much
4 out as we can, and then we will be having some town halls in
5 the Spring, which we will announce. That will give us a
6 chance for people to make input when they have a document
7 they can focus on.

8 Our thinking here was it was better to wait until
9 we had a document that people could focus on rather than just
10 having general testimony or general submissions.

11 I think that will sort of end my introductory
12 remarks and just move to the next point, which is
13 international considerations.

14 Before I do that, are there any questions that
15 anyone has about the way we work this meeting and the process
16 here?

17 (No response.)

18 INTERNATIONAL CONSIDERATIONS

19 CHAIRMAN POZEN: On international considerations,
20 as you can see from the document, we are working on two
21 premises.

22 One is that FASB and IASB will both be around for a
23 while. The reason why that is an important premise is that
24 we want to continue to do the good work of Subcommittee 2 and
25 other groups that relate to the process of standard setting

1 in U.S. GAAP.

2 Quite frankly, we are not in a position to judge
3 exactly when IASB would fold together with FASB and when
4 there would be complete convergence.

5 I guess we are making a reasonable estimate that
6 this is going to be around for a while. Whether it is three
7 years or five years or ten years, I do not think we are in a
8 position to evaluate.

9 I guess my own cynicism about these things is they
10 take longer rather than shorter. I, myself, am not worried
11 about Bob Herz losing his job right away in the next year or
12 two. Don't plan to give up your apartment in Norwalk.

13 The second premise that we have is obviously we all
14 as a group support convergence. In the process of doing the
15 work on the various sections, we want to continue to point
16 out things that would promote convergence and urge people.

17 I think you will find, for instance, in
18 Subcommittee 1, they talk about moving away from industry
19 specific standards and they urge IASB, which has not yet
20 developed a lot of industry specific standards, not to make
21 the mistake of going down that road.

22 I think in Subcommittee 2, there is a lot of
23 material there with David's group in terms of coordinating
24 with IASB and making sure that we have projects prioritized
25 correctly.

1 I think the sort of thing that Subcommittee 3 did
2 on judgment is important, critical, to long term convergence
3 since if we are going to converge, we will probably have a
4 more principle based system, although I think we would have
5 both principle and rules, so a framework for judgment becomes
6 very important.

7 I think the sort of work we are doing on XBRL again
8 is the sort of thing that we would want to make sure that it
9 is done on a global basis.

10 I think there are lots of things. The third point
11 is I believe that it would be useful and we should have some
12 discussion on this for Subcommittee 2 which has been most
13 involved on the international side, to focus on this issue of
14 convergence over the next six months.

15 I have talked to a lot of people. It's a bit of a
16 complicated decision making process because we are not sure
17 where the Commission is coming out. There are a lot of
18 alternatives. I don't think our role is to make the
19 political decision, but our role is to provide technical
20 assistance.

21 I think the idea would be for Subcommittee 2 to
22 sort of focus on sort of a conditional set of questions, that
23 is saying if we want to promote convergence, here are the
24 sort of issues we would have to resolve. Here are the sort
25 of steps we would have to resolve.

1 If we get to convergence through scenario A, then
2 maybe here are some new issues that might have to be
3 resolved. If we get to convergence through scenario B, then
4 here is a set of other issues that would have to be resolved.

5 I think we all have seen the Commission's
6 conceptual release so that we know there are several
7 different ways in which we can get to convergence.

8 I believe that delineation of the issues, the
9 delineation of the steps would be helpful to the Commission
10 in sort of deciding which way to go and coming to grips with
11 some of the practical problems that we might see.

12 I don't know, David, whether you want to say
13 anything about that.

14 MR. SIDWELL: No, we agree with that. Actually,
15 one of the things we have done is to try and put our thinking
16 in the context of what is an ideal system, thinking about
17 things like governance, how standards get determined, how
18 interpretation works.

19 I think we have a framework to think through the
20 way you frame the issue and we will get on with that as soon
21 as this meeting is over.

22 CHAIRMAN POZEN: Can we have comment from any other
23 members of the Committee or anyone else who wants to talk
24 about whether that seems like a reasonable approach?

25 Greg?

1 MR. JONAS: Bob, I think there are two things about
2 the globalization of accounting standards that I think we have
3 to address to give some directional consistency with all the
4 more detailed recommendations that we might come up with.

5 One is related to the convergence strategy. I
6 think there are two broad strategies we could go with. One
7 is to continue convergence as we know that today, which means
8 joint projects, common answers over time, and at some point
9 in some indefinite future, probably the long term, we are
10 going to be close enough in the two standards that there is
11 no substantive difference and we have arrived at the promised
12 land, and then we can turn the keys over to the global
13 standard setters. Strategy one.

14 Strategy two is no, we are going to pick a date
15 certain, not tomorrow, but five years, who knows when, but
16 pick a date certain and say by this date, we are all going to
17 be on the global standards train.

18 We are going to hustle toward convergence until
19 that date, but whatever remains un-converged by that date,
20 it's over. We are all going to jump on that train.

21 It seems to me those are two very different
22 strategies and could affect a number of this Committee's
23 recommendations in a more detailed sense, and I would
24 encourage us to pick one.

25 The second point that I can't see us not addressing

1 or I think it would be helpful to address is what is the end
2 game with standards setting?

3 Meaning after convergence or after we get on global
4 standards, what does the standard-setting process look like,
5 both globally and importantly, in the U.S., and how does the
6 U.S. fit into that?

7 The reason I say it seems we have to answer that
8 question is the old adage about if you don't know where
9 you're going, any road gets you there.

10 We have a ton of very good recommendations relating
11 to the FASB but if you don't have the end game in mind, I'm
12 having difficulty judging whether those sort term
13 recommendations are consistent with some longer term vision.

14 CHAIRMAN POZEN: I believe David's group is already
15 focused on this issue of what is the end game, assuming, as
16 we all believe, that convergence will be the end game, what
17 is the appropriate standard-setting process, what is the
18 appropriate governance process.

19 I think that will be in a sense their first piece
20 of work. You delineated two, and I think there probably are
21 at least three different paths.

22 One is you might say just long term convergence as
23 you get closer and closer. A second is pick a date certain,
24 and third is what is sometimes called optionality, where U.S.
25 issuers would have a choice between IFRS and U.S. GAAP.

1 David will correct me if I'm wrong. I think our
2 approach would be to say here's what we need at the state of
3 convergence in terms of standard setting, governance, et
4 cetera.

5 If we go toward convergence through path A, here
6 are some of the additional issues we would have to deal with.
7 If we go get to convergence through path B, optionality, here
8 are another set of issues.

9 I think that gives us the best approach because we
10 do have the ultimate goal in mind but we are not sure and we
11 are really not in a position to pick the path and what we are
12 hopefully doing is by identifying some of the issues and
13 steps that would be involved in the different paths, it would
14 help that decision making process.

15 David, again?

16 MR. SIDWELL: No, I agree with that. I think we
17 are going to have to address it. If you think of one aspect,
18 even if you have a converged standard, the way that standard
19 gets interpreted is something that we think is critically
20 important.

21 You could end up with a situation where on paper,
22 it looks like the same standard, but the way it is being
23 interpreted if you have totally different systems of
24 interpretation for IFRS versus the U.S. version, we are going
25 to have to come up with some recommendations that help with

1 that.

2 I think it does both answer the near term issue and
3 also if you do get to a point where you are on one set of
4 global standards, what you think is the right system for
5 interpretation.

6 I think by definition we are going to have to
7 answer both questions.

8 CHAIRMAN POZEN: Jeff?

9 MR. DIERMEIER: I would just add, Bob, to your end
10 game, et cetera, funding as well.

11 CHAIRMAN POZEN: I think that is an important
12 issue, funding. I think governance is another issue. We
13 have spent all this time with FAF and these sort of things.

14 I think these are the sorts of issues we would have
15 to address. Ed?

16 MR. McCLAMMY: Yes, I agree with Greg. I feel that
17 we should out of this Committee make a recommendation on
18 which of these paths we feel would be the best to go down.

19 As I have sat here and listened and read through
20 this document, I think this transition is causing a lot of
21 the complexity that we are dealing with, just based on the
22 pace of change that's going on, and a lot of that pace of
23 change is being driven by trying to get through this gradual
24 convergence and getting to a magical end point.

25 I think it would be worthwhile to address that.

1 CHAIRMAN POZEN: Ed, I just want to try to pin this
2 down. We are going to address, as David says, the end game
3 and what that looks like. Then we will sort of as a second
4 and third analysis say if you go down this path, here are
5 these issues, if you go down that path.

6 I think we should be reticent as a committee to say
7 this is the path to go to versus that's the path to go to.
8 This is clearly a political issue. It has clearly been teed
9 up by the Commission in its comments.

10 I feel like our contribution would be maximized if
11 we can delineate essentially the issues and the steps that
12 differentiate one path versus another, rather than our trying
13 to sort of come out politically.

14 I just do not want to leave that point ambiguous.
15 I think there is a difference between what we are doing. I
16 believe that what we are going to do will be helpful, that
17 there will be many people weighing in for and against and
18 hopefully we can bring to bear more analysis than heat, to
19 sort of summarize. Any more comments or questions on the
20 international?

21 (No response.)

22 I appreciate David's subcommittee and willingness to
23 do this. This is definitely a big undertaking. I know that
24 it is very important. I think we are in flux. I do not
25 think there is any way we can sort of get away from this, but

1 I think by setting a sort of ideal end point, as Greg says,
2 and what that looks like, and then sort of thinking about the
3 different paths, I believe we can contribute something to
4 that analysis.

5 I think now, unless there are other questions on
6 that, we are going to get to the meat of the business and
7 look at the proposals by Subcommittee 4.

8 I guess I should say before that, we do have in the
9 introduction a definition of "complexity" and causes of
10 complexity, which I am not going to go over, but I thank
11 Denny Beresford for his very good work on that.

12 I would say I am sure that people will say it
13 should be embellished this way or that way, but I think it is
14 a pretty good working definition, quite a good definition,
15 and it tries to most importantly distinguish between
16 avoidable complexity and just complexity.

17 I think we all realize that some complexity is
18 unavoidable and some is avoidable. Obviously, we want to
19 concentrate on avoidability.

20 The second thing which I think is important in the
21 introduction is that we are emphasizing the user perspective,
22 investor perspective, so this is a combination of
23 emphasizing, making financial information more useful to
24 investors, and at the same time, reducing the complexity as
25 one of the strategies.

1 Let's turn to Chapter 5, which is Subcommittee 4,
2 I'm sorry for the slight mismatch of numbers. We numbered
3 the introduction one.

4 The chapter begins at 74. There are a number of
5 questions that Jeff, I had asked you to focus on. I think
6 probably we want to get to page 84 pretty quickly. That is
7 where we start to have the proposals.

8 DISCUSSION OF DEVELOPMENTS SINCE NOVEMBER MEETING

9 SUBCOMMITTEE 4 - DELIVERING FINANCIAL INFORMATION

10 MR. DIERMEIER: Thank you, Bob. I want to thank
11 Amy Starr and Holly Barker for their good effort, the work of
12 my colleagues on Subcommittee 4, and I particularly want to
13 commend my colleagues on this Committee for the wonderful
14 work that you have done in your other sections. I think to
15 me, it looks like some excellent work has been done.

16 We have two developed proposals, XBRL and web
17 sites. Page 84, according to my numerology, is where we have
18 developed proposal 5.1. You have heard from us before.

19 Of all the many people we have talked to about
20 XBRL, they all believe that bringing this modern technology
21 to reporting benefits all. It is a little bit like what they
22 used to call "progress."

23 The end game is that in time, we would like
24 companies to file their formal documents using XBRL, as they
25 likely would non-XBRL submissions.

1 The question is how do we get from the voluntary
2 program that we currently are in to ultimately the end game.

3 We do not believe, although it was a subject of
4 active discussion, that we can go straight to filing under
5 XBRL. There are some pre-conditions that were listed in the
6 piece. There are learning curve issues. There is experience
7 that seems it requires an interim phase in, and that phase in
8 could accommodate that learning.

9 The "phase in" would be first mandated that the
10 largest 500 would furnish financials in single block tag
11 footnotes, so not footnotes that are reduced down into small
12 pieces, that roughly a year later, the phase in would move to
13 domestic large accelerated, so that would be a combination of
14 almost 1,900 companies by that point.

15 After that, hopefully and presuming the pre-
16 conditions are met, the SEC could determine whether to
17 go to the end game.

18 We spent a fair amount of time, as you might
19 imagine, talking about assurance. We believe the cost of
20 assurance, if limited to things like just the tags and making
21 sure the rendered statements match up with the filed in the
22 interim process, basically could be low and acceptable to
23 all, that the costs and benefits, we know, would likely vary,
24 depending on where in the process and the chain from the
25 trial balance to the end filed financials would the tagging

1 actually occur.

2 We also know that some of our members on the
3 Committee really would desire that there would be even some
4 assurance in the interim time frame.

5 The fact of the matter is that presumption that we
6 would like some assurance in that regard is premised on the
7 notion that the costs would be extremely low.

8 What we put here for a tier is basically a notion
9 that we would document during the phase in what those costs
10 are. Rather than put the cart before the horse and rather
11 than assert that cost would be low in terms of doing anything
12 like that, let's study it during the phase in period and find
13 out what the costs would be.

14 This whole process to some of us, to myself, seems
15 like it could be rather simple, but in the end, we want to
16 assure that some people don't come along and try to
17 complicate and over complicate this.

18 That is basically why we have the proposals set the
19 way we do, and that is also why we are suggesting that in the
20 assurance section there in fact would be some kind of
21 voluntary program, a number of companies would actually go
22 through the process of trying to work on assurance to
23 estimate what those costs actually might be so that we would
24 have an informed decision going forward.

25 CHAIRMAN POZEN: That is an excellent summary of

1 where the Subcommittee has come out. I think we all tend to
2 know XBRL a lot better than the rest of the world. I was
3 shocked. I was at an audit committee of a Fortune 100
4 company and several people there hadn't even heard of XBRL.

5 I think there is a bit of a learning curve. I
6 think Jeff's proposal here tries to give us a staged approach
7 in which we can learn, and a lot of things that are happening
8 in the software development area seem to be happening, and
9 they are all very positive.

10 The idea is to sort of take more of a phased in
11 approach and an empirical approach, which hopefully will get
12 to where we want.

13 I think we should open this up to discussion.
14 Peter, I know you have strong views on this, to say the
15 least.

16 MR. WALLISON: Just strongly expressed, Bob.

17 (Laughter.)

18 CHAIRMAN POZEN: I don't know. My wife's a
19 psychotherapist. I have to distinguish between strongly
20 expressed and strong views. I would have to think about that
21 one for a while.

22 MR. WALLISON: I'm a representative of the XBRL
23 community on this Committee. I do take this seriously. I
24 think we have to consider some of the issues.

25 The main question I think we have been involved

1 with in our subcommittee is this question of assurance. We
2 have not been able to establish by talking to the accounting
3 profession what assurance will cost.

4 If you read this portion of our paper, you will see
5 there are some things that have to be done in order to
6 achieve assurance of one thing, and that is simply the
7 question of when you map in what we are calling the bolt on
8 situation, where you create your financial statement, as you
9 do today, an audited financial statement, on paper, and then
10 you map the items in that financial statement, revenue, cash,
11 all the rest of the items, to XBRL, that, everyone agrees is
12 simply done by various software that is available, but the
13 question is have you mapped it accurately.

14 Have you perhaps taken the revenue item and put it
15 into the wrong category in the XBRL taxonomy.

16 The question is if accountants are going to look at
17 that or auditors are going to look at that, how much is it
18 going to cost.

19 We have gone around and around about this, and I
20 understand the position of my colleagues on this Subcommittee
21 4, that we ought to have an experiment and see how much it
22 actually costs.

23 The problem with something like that to my mind, at
24 least, is that it will delay the application and use of XBRL
25 for at least a year and maybe even longer than that.

1 We are already well behind other countries in using
2 XBRL for financial reporting. It does not appear to me that
3 is necessary.

4 Let me just give you one example of how assurance
5 can be done. The question we are talking about is whether
6 you can demonstrate that the mapping from the audited
7 financial statement to XBRL has been accurate.

8 One way to do that is simply to use the XBRL
9 material, the XBRL format, and print out from that, and
10 almost all of the report writer's software will do this,
11 print out a copy of the financial statement.

12 Then you compare what is printed out from XBRL to
13 the audited financial statement that the accountants have
14 audited, and you see if there are any differences.

15 If there are no differences, then in fact, the
16 mapping has to have been correct.

17 I cannot see that that process, which is called by
18 the accountants "re-performance," would be particularly
19 expensive. Yet, we are all afraid -- unfortunately, this is
20 a problem mostly with the accounting profession. People are
21 afraid that what has happened with Section 404 of Sarbanes-
22 Oxley will be the sort of thing that the accountants will do
23 to everybody when they get hold of this new idea.

24 But if the Committee looks carefully at what is
25 required for assurance, it should be clear that assurance can

1 be done exceedingly cheaply, as I just described.

2 There is a second factor also, and that is the
3 Subcommittee is recommending two separate documents at first.
4 One is the regular audited financial statement, which is, as
5 we would call it, human readable, and the other is all the
6 XBRL formatted material bolted on and sent to the SEC
7 separately, not filed but furnished.

8 The idea there is that if it is just furnished,
9 there is not the same degree of liability as if it is filed.
10 All that is true. We are assuming there will be two separate
11 documents.

12 XBRL International is about to complete some
13 specifications that will allow the creation of something
14 called a "micro format document." When things are printed
15 out today, they are printed out in HTML. They are printed
16 out in PDF form. They are printed out in Word. We all
17 understand those things. We have seen them.

18 The micro format document is going to be quite
19 different. It will allow either the financial statement to
20 be printed out in human readable form or the XBRL
21 documentation downloaded into a spreadsheet or into a model,
22 from exactly the same document, coming out of exactly the
23 same database.

24 In other words, they are able to combine the
25 rendering ability, the printing out for human consumption,

1 with the data capability, which is downloading into analyst
2 spreadsheets and so forth.

3 If we go forward with two separate documents, as we
4 are discussing in our Subcommittee and has been presented to
5 this Committee, we make that new micro format unworkable
6 because you cannot have two separate documents.

7 That new format will be available in May. It will
8 be very simple for everyone to use. Software manufacturers
9 will create a plug-in that will make it possible to use
10 existing software to create this new document.

11 After that is done, companies can simply file and
12 anyone that gets that material from the SEC's web site, when
13 the SEC's web site can accept it, will be able to print out
14 on the one hand a human readable document or download the
15 same database in its XBRL format into an analyst model.

16 If we have two separate documents, one furnished
17 and one filed, I don't think that can work.

18 I think we have allowed ourselves to be a little
19 bit frightened by this idea of assurance when we could look
20 at how simple it is and say to ourselves there is no way that
21 the accounting profession can make something like this into a
22 Section 404.

23 That is my point.

24 CHAIRMAN POZEN: Thank you, Peter. That is an
25 articulate viewpoint. I just want to be clear that something

1 that is furnished is still subject to 10b-5 liability,
2 something that is filed would be subject to a broader set of
3 liabilities. I do not want people to think that "furnished"
4 means that you can just furnish whatever happens to come over
5 the transom.

6 I think Peter has spent a lot of time on this, and
7 surely is technologically way ahead of me.

8 MR. HERZ: I guess it seems to me just kind of
9 conceptually the issue is in the marketplace, to what degree
10 whatever is going to be provided and XBRL is going to be
11 used and relied upon, the perceptions of the marketplace.

12 Therefore, to me the question of assurance kind of
13 rests on that. If you want there to be reliance on that and
14 broad use of that rather than the hard copy or things that
15 are put into other databases or whatever, then it seems to me
16 eventually you are going to want assurance over it.

17 It seems to me the goals ought to be that there is
18 assurance over it, but that is dependent, I think, at any
19 point as to what degree of use and reliance there is and is
20 the goal, that everything be done on XBRL and that is what
21 they use to do analysis and comparison and all that.

22 It is not clear to me why you would not want
23 assurance around that.

24 CHAIRMAN POZEN: Just to be clear, I think what we
25 are talking about is a phase in period, not the ultimate. I

1 think Peter would tell us that at some point, and he may
2 think it is sooner rather than other people later, we will
3 have some sort of full integration from a technological point
4 of view in which this whole question may become a bit moot.

5 I do think we have to consider sort of where the
6 end game is and how we get there.

7 Michael?

8 MR. COOK: I have a question and an observation.
9 The question would be you mentioned, Peter and Jeff, that
10 this is done in a number of other countries. I was just
11 curious as to what those countries have concluded they need
12 with respect to assurance.

13 It seems troubling to me the notion that something
14 as important as this is going to be delayed whether it is one
15 year or two years or some period in between. I have no way
16 of judging that. It would be delayed for that length of time
17 by the lack of resolution about this question of assurance.

18 I would point out, as your group will be looking
19 more at some of these other things, things of business
20 metrics and performance measures and things of that kind,
21 which are extremely important to the marketplace or are in
22 the marketplace today without any assurance being provided on
23 those, and the marketplace is dependent upon the various 10b-
24 5 issues and the integrity of the issuers and so on.

25 I would suggest that perhaps the assurance around a

1 mechanical -- important -- but mechanical convergence of
2 information might be less important than having assurance
3 around some of the very basic information that the
4 marketplace is trading on today that is not subject to that
5 at all.

6 I am not sure that I get to the conclusion that
7 assurance here is absolutely essential, particularly if one
8 of the costs of assurance is delay. Not the dollar cost but
9 the delay that revolves around figuring out what the cost is
10 ultimately going to be.

11 I would question that. I would question the
12 tradeoffs as you do a cost/benefit analysis and we have
13 subcommittees that say we ought to do better cost/benefit
14 analysis.

15 One of the questions here is what is the benefit
16 and what is the cost, and are there costs and benefits around
17 having this done by the auditing firm or the accounting
18 profession.

19 This is not something for which their educational
20 background or training is necessarily required, a tradeoff
21 being that efficiency comes from the knowledge of the company
22 and how the company produces its financial information, and
23 it might be a very valid benefit to having your accounting
24 firm doing that because having a third party doing it might
25 be unduly costly and perhaps riskier because of that lack of

1 knowledge base.

2 I would just ask the question here of why there is
3 a conclusion, a certainty, around the need for assurance and
4 in particular, if it can cause what I think would be the most
5 unjustifiable cost, which is an undue delay.

6 MR. WALLISON: Can I respond to that?

7 CHAIRMAN POZEN: I think we have a number of other
8 comments and then we will give you a chance.

9 MR. DIERMEIER: To answer the question about what
10 is done in other countries, just as a matter of fact --

11 MR. WALLISON: What I have been told is there is
12 not assurance in other countries and that we are further
13 along in thinking about this than most other countries and in
14 trying to address some of these issues.

15 MR. COOK: They have this information in the
16 marketplace today in other countries without assurance and we
17 think we couldn't take that same view?

18 MR. DIERMEIER: That would be too broad of a
19 statement because I would say parts and bits.

20 CHAIRMAN POZEN: I do think I can say from the
21 investors' viewpoint that what Michael is saying is when you
22 look at press releases and non-GAAP financials, which are
23 critical to valuations, we don't ask for auditor assurance on
24 those.

25 I think part of the idea here would be that during

1 the phase in period, Bob, that we would look to see what is
2 the analyst reaction or do they consider this to be enough
3 comfort or not. Maybe the market can police this, if
4 somebody was really way off, I think maybe that would be.

5 Linda?

6 MS. GRIGGS: I just want to echo some of what Mike
7 said. I don't see any need for assurance. There are a lot
8 of numbers in a document filed with the SEC that are not
9 covered by assurance.

10 There is an attestation standard for the MD&A that
11 has very rarely been used, maybe once it has been used, to my
12 knowledge.

13 Where in fact people feel that there has to be a
14 greater degree of assurance in the context of securities
15 offerings, there are comfort letter processes. There is a
16 way for the marketplace to demand additional assurance when
17 it is needed.

18 If it is just a function of taking a number and
19 picking the taxonomy, and I understand there are judgments,
20 and those are important judgments, it seems to me companies
21 can do that internally.

22 If there is any concern about the company paying
23 enough attention to it, you can have the certification, which
24 I believe the Subcommittee has suggested.

25 I personally believe that during the phase in

1 process, this document should be a separate document. It
2 should be furnished. I know how companies struggle over the
3 higher level of liability that you have for a filed document.
4 We struggle over that with 8-Ks on a daily basis.

5 This would avoid that source of concern that there
6 might be liability, and you could have a certification to the
7 XBRL statements in the separate document which would then do
8 what the certifications under 302 have done, which is to
9 cause companies to put in procedures where there is a double
10 check.

11 All of us like to have our work checked. That
12 could happen very easily through a certification process.

13 CHAIRMAN POZEN: By a "certification process," you
14 are talking about --

15 MS. GRIGGS: By management, a management
16 certification process.

17 I think during a phase in process, you certainly do
18 not want assurance. It strikes me that once the whole system
19 is built from the ground up, it sounds like your audit
20 opinion will cover the financial statements as they are
21 produced, and they are produced using the tag. You do not
22 need a separate assurance opinion at that point.

23 I just want to speak also to this question as to
24 whether XBRL should be mandated. I am concerned about
25 mandating it now. In addition to the pre-conditions that the

1 Subcommittee has highlighted in their paper, it seems to me
2 that our Committee is coming up with lots of ideas for ways
3 to reduce complexity, some of which will change the financial
4 statements, assuming that is what the FASB decides makes
5 sense.

6 I am troubled by having people start developing --
7 not developing but tagging their financial statements when we
8 are in the process of perhaps changing financial statements.

9 I am troubled by having these major corporations
10 start doing the tagging if in fact the Commission is going to
11 decide that they can either on an optional basis or be
12 required to prepare IFRS financial statements.

13 Maybe we want to wait to make a decision on the
14 timing of mandating for those two pre-conditions as well.
15 Let the Commission decide what is the timing on IFRS. If it
16 is a long period of time, then maybe it does make sense to
17 have companies tag financial statements using U.S. GAAP even
18 though if they go to IFRS, they are going to have to tag
19 financial statements using IFRS.

20 Those are my points.

21 CHAIRMAN POZEN: Thank you. I have Denny, Greg and
22 then Tom.

23 MR. BERESFORD: I just want to speak in favor of
24 the Subcommittee's conclusions. It seems to me it is a
25 reasonable compromise, a reasonable position, sort of between

1 Peter and Linda, I guess you might say at this point in time.

2 I hesitate to speak on behalf of auditors, but I
3 recall there is an auditing requirement to look at other
4 parts of SEC filings to see that they are not inconsistent
5 with the audited financial statements.

6 It seems to me that at a minimum, this would be
7 covered by that, without a whole lot of extra costs.

8 I think where the Subcommittee is right now is a
9 very appropriate place.

10 CHAIRMAN POZEN: Greg?

11 MR. JONAS: I, too, would like to speak out in
12 support of the Subcommittee's recommendation for exactly the
13 reasons Denny mentioned.

14 I would also like to observe that I perceive
15 significant benefit if not an essential benefit to having
16 some assurance over these tags. My rationale is really quite
17 simple, and that is I think today, most sophisticated users
18 have databases of data. We do not often dwell in the hard
19 copy financial statements.

20 Today, we build these things through, at least in
21 our shop, a lot of manual processes. We have a team of
22 people dedicated solely to building a database.

23 One of the reasons we are enthusiastic about XBRL,
24 among others, is its ability to automate that building
25 process. As such, I can promise you that when tagged, we are

1 going to run with those tags. We are not going to look back
2 and we are not going to perform all kinds of checks. We are
3 going to run with them just as today we run with the numbers
4 that are printed on the face of the financials.

5 If the tags are wrong, we are going to be building
6 wrong databases. Maybe that is a sustainable state as a
7 temporary condition, but I sure would not think that is
8 sustainable in the long term.

9 CHAIRMAN POZEN: Tom and then Jim.

10 MR. WEATHERFORD: Peter and I have had several
11 discussions on this. As a former CFO and having grown up in
12 the business intelligence space, the devil is in the details
13 here.

14 It seems simple on paper, but to actually go off
15 and implement it across 13,000 companies in the U.S., from
16 mega-companies to small companies, it is not that simple.

17 I think today if you look at 90 percent of the
18 indices that are given out by CFOs and COs to the investment
19 Wall Street today, these are not numbers that are in a 10-Q
20 or a 10-K.

21 The question is what gets tagged and what does not
22 get tagged. If you say everything, every indices that a
23 company talks to Wall Street about gets tagged, what you are
24 going to do is you are going to limit the number of indices
25 that the company will share with Wall Street. That is my

1 concern.

2 If you are talking about basic numbers like
3 revenue, cost of sales, operating expenses, getting that
4 tagged so you can do a simple EBITDA, it makes sense. I like
5 the phased in approach to this.

6 If you go below that to channels and distribution
7 of revenue, which are sometimes very complex to get done and
8 in the time that you have to do your reporting, I think you
9 are going to see companies report less.

10 What I like about what companies do today on the
11 non-assured numbers that they do give out the indices that
12 are relevant to their business, which may not be relevant to
13 other businesses. I think the investment community
14 understands that.

15 I like the phased in approach. I think the
16 assurance is a lot more expensive than we are willing to
17 admit. I think if we went back and looked at 404 and the
18 start of 404, we would have said the same thing about 404,
19 and now it is difficult to get those costs reduced, even
20 though we have Auditing Standard 5, because it is part of the
21 audit process, and that is no one's fault, it is just
22 reality.

23 I think we should just really take this slowly. We
24 do have the convergence of international versus GAAP
25 standards. That is going to maybe change the look of the

1 P&L, the income statement, et cetera.

2 I do not think we want to get the cart before the
3 horse here.

4 CHAIRMAN POZEN: Jim?

5 MR. QUIGLEY: Just a comment on the conceptual
6 issue with respect to assurance. I think some of us are sort
7 of listening to this discussion and saying why is this a big
8 deal.

9 One of the conceptual questions that we would have
10 to really understand is what does the marketplace want and
11 what is it they expect, and what is Greg looking for when he
12 pulls this tagged data into a model, and does he believe that
13 he has assurance on that individual data point because what
14 the audit firms have done is expressed an opinion on
15 financial statements taken as a whole, and the auditors have
16 not expressed an opinion on every individual data point.

17 The notion of conceptually what do we really mean
18 by "assurance" and what is being sought has to be resolved.
19 It is a non-trivial point.

20 The additional assurance with respect to other
21 information filed with audited financial statements that
22 Denny referred to, that's other information included in a
23 document that the audited financial statements are included
24 in.

25 If this is furnished separate from that, then I do

1 not believe that provision of the auditing standards would
2 apply.

3 Finally, it is not clear to me why the notion of
4 field testing is rejected or why the notion of field testing
5 actually puts additional time into what is already a phased
6 in approach that you have outlined here.

7 We could in the phased in approach for some of
8 these companies decide what is the model of assurance that is
9 being sought and then how would we provide the assurance that
10 is being sought, and I think that can be done without
11 impacting the time table that you have outlined here.

12 CHAIRMAN POZEN: Thank you. I think John may want
13 to speak to this. I think you are very right about the phase
14 in and the time frame.

15 I do not think the Commission intends to bring this
16 in instantaneously. I think the Commission's intent is to
17 bring it in in the phase in which will happen regardless
18 of what this Committee will do, so there is time to deal with
19 these issues.

20 Secondly, you raised a very good point, I think,
21 about the conceptual question, would the assurance be on each
22 and every tag or would it piggy on the materiality of the
23 whole thing. That is a very good question.

24 I think a third point which Peter has convinced me
25 of, but I just do not know the timing, at some point there

1 will be a software which may make the whole assurance
2 question moot, because it will so fully integrate everything.

3 Maybe it is coming in May. I do not know. My
4 experience with software projects is they are always late and
5 over budget. If somebody knows how to solve that problem, I
6 would like to know it right now.

7 It may be the case that during this phase in period
8 which will be there, we should not just test out assurances
9 and bolt on's, we should also be looking at where the
10 software is going. It may be the case that the software will
11 ultimately sort of bring together these two documents. I am
12 sure it will.

13 John, I assume you are going to have a phase in
14 approach no matter what.

15 MR. WHITE: The short answer is yes. I think it is
16 even one step before that. I do not see us requiring any
17 companies to provide -- I will use "provide" so I do not use
18 "furnish or "file" -- to provide us with XBRL tagged data
19 until companies in the voluntary program have voluntarily
20 chosen to provide us with information, and that we know the
21 new taxonomy that has been written works. We know the EDGAR
22 system can accept it or you can use it in the EDGAR system,
23 and that we have a reader so you can read it.

24 Until we can demonstrate all those things happen in
25 a reasonably workable way as part of the existing voluntary

1 program, I do not even think you get to the point of
2 requiring 500 companies to do whatever you would require them
3 to do.

4 CHAIRMAN POZEN: We did try to not have a specific
5 date on that compromise proposal and leave that open. I
6 think the points you make are well taken.

7 MR. WHITE: The rest of the answer is yes. I think
8 500 companies and then 1,700 or 1,900. Those are reasonable
9 steps, whether you do a two or three step and so on.

10 CHAIRMAN POZEN: I think there has been a good
11 discussion. If there is anyone who has not talked, Ed, who
12 wants to say something, I want to make sure that we give
13 everyone a chance.

14 Ed?

15 MR. McCLAMMY: Yes, a couple of comments. As far
16 as the level of detail required, because it is not very
17 specific in here, I guess my belief is that the required
18 detail should be no more than what is currently required
19 under SEC regs. I think that is a very important point, that
20 is all that should be required, and then anything other than
21 that should be voluntary additional disclosures.

22 That may get back to this point on assurance, is
23 there assurance on those primary SEC required financials
24 taken as a whole versus a lot of additional information.

25 I think if we start getting into requiring a lot of

1 additional information, certainly it should then come through
2 the SEC, this is additional useful information to investors
3 that should be tagged, it should not come through any other
4 group.

5 The other one on the time frame, I was very glad to
6 see the specific date was taken out. I think it is probably
7 worthwhile to also be more vague on how soon the further roll
8 out would happen after the 500.

9 I think just as John said, then you have a three
10 stage approach that can get through the voluntary and see how
11 that is going, and then you require the 500, make sure
12 nothing else comes out, and then after you have that, then
13 say here is the time frame for the next wave.

14 MR. WHITE: If we were on the most aggressive
15 schedule, we would put out a proposal in the Spring, which
16 mind you goes all the way to June 20th, but we put out a
17 proposal in the Spring that laid out kind of a road map of
18 how all this would happen, that would include your 500 and so
19 on.

20 During the course of the Summer, we would have the
21 proof of concept that I described, and before the Commission
22 would adopt that proposal with something of a mandatory
23 nature, you would have had the proof that I described
24 initially, that it actually could work, and then you would
25 adopt a final mandatory piece in the Fall, which I remind you

1 goes to December 20th.

2 CHAIRMAN POZEN: Is there anyone else who has not
3 given us comments who wants to? I think we have had a pretty
4 good discussion of these issues. I think Denny put it
5 accurately.

6 The proposal is essentially a compromise. On the
7 one hand, we tend not to want to go the way Linda is
8 suggesting, to wait, because we want to get it started, and
9 we realize the start will be slow, but we will have this
10 phase in period and we ought to use the phase in period to
11 try to nail down these issues.

12 On the other hand, I think the proposal basically
13 would sort of shy away from requiring an assurance right away
14 until we have worked out a number of these proposals. It may
15 be that during the phase in period, we will quickly resolve
16 these issues or maybe it will be slow.

17 I guess since this one is sufficiently
18 controversial, I am going to take a formal vote to say how
19 many would go along with the Subcommittee proposal? This is
20 just for Committee members. Please raise your hand.

21 (Show of hands.)

22 CHAIRMAN POZEN: How many would disagree?

23 (Show of hands.)

24 CHAIRMAN POZEN: We will record that. I think we
25 surely have learned a lot from Peter's input. I think Peter

1 will surely keep us apprised of the development of the
2 technology. I know you have.

3 I guess those of us who have been a little more --
4 actually ran software projects -- a little more cynical when
5 someone tells you it is going to be ready in May and then
6 when it actually is May -- Chris probably is an expert on
7 that subject even more so than I.

8 I do want to give Jeffrey time for the second part,
9 which I think we are going to have a little show and tell
10 here?

11 MR. DIERMEIER: We are going to have a little show
12 and tell. The next one is improved corporate web site use.
13 Chris and his team have done some really nice work. Let me
14 turn it over to Chris before we actually talk about the
15 proposal.

16 MR. LIDDELL: Let me just make a few introductory
17 comments and then I will give you a presentation.

18 This is something we did for the Subcommittee and
19 they felt good enough about it to suggest that we should give
20 it to the full Committee.

21 It is something that we were doing at Microsoft
22 anyway, but we think it picks up some of the recommendations
23 that we are looking at inside the Subcommittee. We think it
24 will bring the conversation in the next little while alive.

25 What we are going to do is demonstrate what we are

1 doing. We are using all publicly available information.
2 This is a demonstration. It is something that we are
3 actually going to put in production at Microsoft anyway over
4 the next few quarters.

5 It will demonstrate a few things that I want you to
6 think about. XBRL, which we just talked about. It will
7 bring alive some of the richness that XBRL can bring to, in
8 this case, a web site.

9 Tiering, starting with an executive summary and
10 being able to drill down to all information on a company's
11 web site.

12 Hyperlinking, the ability to actually pick up not
13 only SEC filings but press releases, quarterly presentations,
14 and management presentations, so we have all the
15 presentations that people like Bill Gates and Steve Ballmer
16 give, being able to be linked into the site as well, and also
17 KPIs, how we sort and present all of our KPIs, non-financial
18 information of a KPI nature.

19 We will quickly give you a demonstration of how the
20 architecture of a web site can actually bring all that
21 together in a relatively simple fashion.

22 CHAIRMAN POZEN: Through translating KPI key
23 performance indicators, for the audience.

24 MR. LIDDELL: As I say, this is something that is
25 basically using all available information that we have already.

1 We have not created anything new for the demonstration.

2 I will hand it over to Frank Rowe, who is our chief
3 accounting officer, who I know a number of you will meet, and
4 for him to take any questions at the end, and then hand it
5 back to Jeff for a recommendation.

6 SLIDESHOW PRESENTATION BY MICROSOFT

7 MR. ROWE: Let me just preface that what we are
8 showing you here does not use any fancy technology. This is
9 HTML, XBRL. You can see some PowerPoint slides on here as
10 well as Word documents. We are using standard technology, so
11 we feel this is something that most people who are inclined
12 to do so could do.

13 We had in mind to handle any of the investors who
14 may be interested in our company or any company, from the
15 retail investor who may own a few shares to the most
16 sophisticated.

17 We start out at the top level, the summary level,
18 and we have split our approach into performance, which is the
19 current, so individuals can look at how is the company
20 performing today.

21 We show the outlook, what is expected in the near
22 term, and then we will show the strategy for each of the
23 groups, which looks at what are the investments going to do,
24 what does the future for the company look like.

25 Then we have added key performance indicators. We

1 have those at the company level and each of the business or
2 segment levels as you go through this.

3 Let me start with performance. You can see we have
4 added graphs on the last five quarters from our various
5 presentations that we have made that are out on our web site.

6 We also have been using XBRL, we have brought in the
7 overall discussion of performance from the most current 10-Q.
8 By using XBRL, we were able to update this very easily
9 because it just looks at the tags and brings in that
10 particular section.

11 We also have links on here to direct link any of
12 the financial statements to each of our business segments, so
13 people can take the path if they want, as they go through
14 these, and also to any of our annual executive summaries,
15 which we have put together as kind of an annual sort of
16 report based on our last 10-K.

17 In terms of outlook, we have shown what we have
18 given as guidance for the fiscal year, and you can see what
19 our range of guidance has been. Then we have also indicated
20 for investors where our First Call is right now for those
21 indicators. We show specifically where they are.

22 That is helpful and the outlook comes directly out
23 of our last 10-Q.

24 For strategy, we have shown the same thing. This
25 is actually taken from communications from our CEO and our

1 chairman, Bill Gates, to show the detail and summary points,
2 so you can click and add the actual text of the detail as you
3 go through those.

4 This is something that isn't updated as often
5 because the strategy is much more consistent.

6 Let me just show you the power of KPIs. We had
7 heard a lot of comments that companies don't release them. I
8 think we found that we release about 40 different KPIs in
9 total.

10 These are some of the ones at the company level,
11 which drive our whole business, but we provided a simple
12 click where you can get a table of all the KPIs that the
13 company has, and we have shown them both annually and
14 quarterly for the last two years.

15 We have also added a roll over where you actually
16 have a little definition as to what that KPI is, to help the
17 person look at it and see what value it can have.

18 Those are at the most highest level and then we
19 have also provided links again to let the user navigate if
20 they want. If you click on our revenue graph, it will take
21 you to the financial statements for those periods, so we show
22 the income statement, balance sheet, the statement of cash
23 flows and then our segment income and earnings.

24 I think what is interesting here is you can add
25 context in. You will find if you go through this in great

1 detail, the entire 10-Q is here, but if you click on revenue,
2 for instance, you see what the company's revenue recognition
3 policy is. You can get a little more insight, if that is
4 something that you are interested in.

5 If you look at the revenue number and click on
6 that, you can go to the MD&A overview, to any of the
7 footnotes that have that, or we have created a little summary
8 based upon what we share with investors, so we have some
9 graphical representation of the change for the quarter, the
10 summary text again coming out of the 10-Q.

11 You can go directly here to the revenue recognition
12 policies, look at some of the percent changes and then a
13 recap of the quarter and the most high level bullets/forms
14 that would be used in the investor conference at the times of
15 the earnings release.

16 Just to show you on the cash flow statement, we
17 have a link here that will take you to the liquidity section
18 of the MD&A. One of the things Microsoft has been doing, and
19 you can see how companies can tailor some of these, we have
20 had a fairly large stock repurchase program.

21 With that, we can take you right to the section out
22 of item two of the 10-Q to show the actual details of that.
23 If an investor is honed in on a particular issue, they can go
24 directly to that portion.

25 Let me just go into segments because I think this

1 is where the real power comes. We have shown some overall
2 graphical representations of the derivation of our income and
3 profitability and what the operating income or loss has been
4 by segment.

5 We allow drill down here to each of the individual
6 segments. For each one of those, we have provided the same
7 four pieces of information, the current performance,
8 primarily out of the 10-Q.

9 We have provided the individual outlook that we
10 shared on that segment, so a discussion of the business
11 drivers that we expect in the coming year, and what our
12 earnings guidance has been as well as where the investor
13 consensus is on that.

14 We have also provided the strategy. In most
15 companies, I think the strategy is executed at the business
16 level, so we have provided a lot more information as to the
17 strategy, plus this is a slide out of our financial analyst
18 meeting that we hold each year.

19 We have a link where you can go in and see the
20 presentation that our chief operating officer, Kevin Turner,
21 gave at that conference. Here is the actual text of that.
22 You can download his PowerPoints or actually watch a webcast
23 of that directly from this site. If you were interested, you
24 could get the details.

25 A lot of people are interested in current news, so

1 as part of our strategy, we have linked in things, anti-
2 piracy, the stealing of software in certain countries is a
3 big deal.

4 We have shown what Microsoft's approach is in the
5 anti-piracy area, so you can see that as it links into the
6 strategy, as well a complete link to the press announcements
7 regarding this business.

8 With that, too, we again show key performance
9 indicators for that business so you can see them in detail.
10 This is repeated for all of our business segments.

11 That will give you a kind of a taste of what can be
12 done using XBRL and some of the available technologies today.

13 We have at any point that any of the financial
14 statements can be linked directly. If you notice, there is a
15 link on the bottom, you can drop any of these financial
16 statements into Excel and into XBRL or at any point, go to
17 the full 10-Q, if that's the way you are used to reading that.

18 We are hoping to satisfy all the different users in
19 one context.

20 MR. COOK: June 30th, so the first quarter, when we
21 see first quarter of 2008, that's --

22 MR. ROWE: July through September. This is our
23 latest financial information. We will release our second
24 quarter here in a couple of weeks.

25 END OF MICROSOFT SLIDESHOW PRESENTATION

1 CHAIRMAN POZEN: Thank you very much, for that
2 presentation. As you can see, this is really a wonderful way
3 to present an overview for an individual investor and then to
4 allow really quite a sophisticated drill down by segment, by
5 various things.

6 I think this is clearly one of the things that this
7 Committee would like to promote. Obviously, Microsoft is
8 pretty good at this. We would like to have this tiering of
9 information. I think one of the things that is obvious to
10 all of us is that we have very different needs at different
11 levels of investors.

12 This is such a nice tool to get the individual
13 overview and then the drill down.

14 I think within this, the question is sort of what
15 we could do to encourage this. John, you will be glad to
16 know that we are not proposing that we require this. I think
17 Jeff, maybe on page --

18 MR. DIERMEIER: 88.

19 CHAIRMAN POZEN: 88 and 89, we would like to
20 encourage this. We have sort of been thinking about how we
21 could encourage these sorts of things.

22 MR. DIERMEIER: Just two quick comments. On page
23 two of our document, it says under the definition of
24 "complexity," "the state of being difficult to understand and
25 apply." I think we really saw a reduction right there.

1 What we have proposed here is basically an enabler.
2 The last time the SEC has put out a comprehensive release on
3 electronic media was 2000. A lot has changed since 2000.
4 There has been a lot of rules. We just want to make sure
5 that we can remove as much uncertainty and concerns about the
6 treatment of certain web site disclosures, linkages and
7 things like that as possible, so we can move this along.

8 CHAIRMAN POZEN: That is a very important
9 recommendation. A number of the people that we had coming
10 before us saying various lawyers and other people have
11 questioned can you do this, can you do that, various things.

12 With Amy's leadership, we really hope that we could
13 sort of delineate the questions that are bothering people and
14 try to put as many of them to bed so we can encourage this
15 and facilitate this.

16 John?

17 MR. WHITE: I don't know whether I'm supposed to be
18 responding to what you are doing here, but I will respond in
19 any event.

20 I actually have a team in Corporation Finance that
21 is reviewing this now. We are looking at whether we can come
22 up with an interpretative release.

23 CHAIRMAN POZEN: Great. Two great minds thinking
24 together.

25 MR. WHITE: It helps to get motivated.

1 CHAIRMAN POZEN: Maybe one of the things we can do
2 is to have a sharing of that with the Subcommittee, just to
3 make sure that you are covering all the questions bothering
4 people. I think it would really be a good discussion. I
5 think it's great.

6 Bob?

7 MR. HERZ: I would just be interested from Chris or
8 Frank, I think as I mentioned in one of the other meetings,
9 in a former incarnation, I was head of a committee as part of
10 a business reporting research project that looked at this
11 stuff probably in 1999 or 2000, and basically envisioned
12 something similar to what Frank just showed us.

13 At that time, as noted in the materials here, a lot
14 of people said, the lawyers said, no, this is out of the
15 envelope, this is in the envelope, differential liability,
16 and threw up all sorts of barriers to that.

17 With Microsoft's experience, they obviously have
18 developed that, it's available, so as to what extent that was
19 a concern and how they addressed it.

20 MR. LIDDELL: There is nothing that we showed you
21 there that isn't publicly available anyway. We drew on
22 sources which were effectively available on the web site or
23 available in the public domain anyway. All we are doing is
24 putting together a relatively easy architecture to actually
25 access them.

1 For example, things like the KPIs, all of those
2 KPIs exist previous to putting them together in a tabular form,
3 as Frank showed you, we had been giving them out one by one,
4 generally speaking, on quarterly calls. All we have done is
5 brought them together and made them readily available.

6 The liability aspect of what we showed you wasn't
7 really a concern.

8 MS. GRIGGS: Did you have any information that you
9 wanted to put on your web site that you felt you couldn't
10 because of the risk of liability?

11 Would this kind of a Corp Fin effort help you be
12 even more creative?

13 MR. LIDDELL: We are still in a what is this actually
14 going to look like in full production mode. We might hit
15 some barriers as we actually get into it. At this stage, all
16 we did was take our September results and put them into a
17 demonstration of what it might look like.

18 When we actually go into production in the next
19 couple of quarters, we might run into something, but at this
20 stage, it hasn't been a problem.

21 CHAIRMAN POZEN: I think, Linda, maybe it is fair
22 to say that this release would be more geared not to the
23 Microsofts of the world, which are pretty much on the cutting
24 edge, but to try to bring the rest of the world sort of in
25 shooting distance of the cutting edge.

1 There was another proposal about industry best
2 practice, Jeff?

3 MR. DIERMEIER: The other element to this was in
4 terms of web sites. You will probably hear a little bit of
5 that later on in later months when we talk about KPIs,
6 whether in fact there might be an idea of getting industry
7 together to try to make recommendations about the
8 architecture itself, whether there might be some best
9 practices.

10 CHAIRMAN POZEN: I think also, and this may be
11 partly an answer to your question, Bob, the non-GAAP KPIs and
12 these sorts of things. I think this is all in the right
13 direction.

14 Scott?

15 MR. EVANS: I just want to make a comment. I was
16 really struck by this presentation from Microsoft.

17 I think it is a perfect example of the fact that
18 it's not the series of rules and regulations. It is not the
19 disclosures that we have today that keep us from
20 communicating clearly with investors. What is needed is
21 everyone to take the attitude that Microsoft is, that they
22 are trying as a management to communicate with serious retail
23 investors in plain language that they can understand and not
24 sacrifice the full disclosure of complex information to
25 sophisticated users.

1 Even the way they did it and linked with XBRL
2 language enabled the serious retail investor to get
3 sophisticated insights because they served up the footnotes
4 to them in a manner that only sophisticated users can find
5 their way through the thousands of pages of disclosures, but
6 with the management clearly trying to act in the interest of
7 a serious retail investor, they accomplish everything we are
8 trying to legislate with all the rules that we are talking
9 about today.

10 I think it is just a wonderful opportunity to stop
11 and say it's really the desire to communicate to the retail
12 investor and not give up any information. There is really
13 nothing that stops us from doing that today.

14 CHAIRMAN POZEN: Thank you. David?

15 MR. SIDWELL: I was going to say basically the same
16 thing, not as eloquently as Scott, with one other add on,
17 which is I think we need to do everything to encourage an
18 environment that enables companies to experiment with
19 disclosures.

20 I think we should not be trying to create too many
21 boxes, asking people to populate data in. I think you want
22 to really see this having some enduring life. I think that
23 is about creating the environment which enables companies to
24 get information which is useful in the way Scott said, not
25 that it has to be in any one defined form.

1 What is interesting to me is if you had this
2 available today, which parts of the data would be having the
3 most clicks. You might find it is actually the one we didn't
4 talk to, which was the section called "Investor Presentations
5 and Speeches." Actually, it's often the most timely
6 information that people are trying to get a hold of.

7 I think we really do need to encourage an
8 environment of openness and transparency and timeliness and
9 not get too focused on what are the boxes.

10 CHAIRMAN POZEN: Con?

11 MR. HEWITT: I think it's an excellent
12 recommendation. I think it lends itself to an SEC roundtable
13 where you have the best practices of various types of
14 industries, but I would be very interested also on the user
15 side of this thing, what additional information do we need
16 for the KPIs and so forth. I think it would be a great
17 roundtable.

18 CHAIRMAN POZEN: Bill?

19 MR. MANN: As representing individual investors, we
20 couldn't be more excited about this presentation. Chris made
21 an off handed comment. I don't remember the exact number, so
22 I will just make one up.

23 The KPIs that they came up with came from speeches,
24 they came from presentations, like 17 different places, for
25 someone for whom this is not how they make their living, it

1 will be almost impossible to aggregate, so to have it all in
2 one place.

3 I think the one thing that we do need to recognize
4 and David said this, we do not necessarily know what people
5 are going to value the most in these types of presentations.

6 Just to have things aggregated in one place and
7 being able to track them, I think, is going to be very
8 interesting in terms of determining the best practices for
9 these types of web sites.

10 CHAIRMAN POZEN: John and then Jeff.

11 MR. WHITE: I just want to make clear, you are not
12 suggesting that we should be mandating additional disclosure;
13 correct?

14 CHAIRMAN POZEN: No, absolutely not. We want to
15 encourage, set examples, eliminate any legal constraints, but
16 we are not mandating.

17 Jeff?

18 MR. DIERMEIER: I'm sure Chris would think I'm not
19 talking out of school, but from the standpoint of he
20 indicated this tool is very helpful internally as well,
21 particularly for those people that might speak about the
22 organization, large organization, many complex things.

23 Having all the KPIs organized in one place, the
24 benefits go in all directions.

25 CHAIRMAN POZEN: I think that we can say these

1 recommendations, not mandating, but encouraging our consensus
2 issues, and I did want to point out two other things.

3 One is that this Committee will then be talking
4 about KPIs, press releases, and getting further into this.

5 I did want to get feedback from the Committee on
6 one point on page 89, just to make sure that we understood
7 the Committee. There was a little discussion about executive
8 summaries.

9 Mike, you mentioned, if I remember, that this had
10 not been successful. There was some debate, I guess, as to
11 whether the idea was -- the idea is still in here, executive
12 summaries, but now integrated as part of a document.

13 I just wanted to get the sense from you, Mike, and
14 other people, whether this seemed to be an area that we
15 should be exploring.

16 MR. COOK: Bob, I made a note on the first page
17 with respect to this. Only in terms of the issues that the
18 Subcommittee will address in the amount of time that is
19 available to do that, and I would have the second, third and
20 fourth items, if I were prioritizing on a one to five scale,
21 I would have them each as probably a five or at least a four.

22 I think this executive summary/executive summary
23 report was a great idea at one point in time, whose time has
24 come and gone, and been succeeded by other forms of
25 reporting, earnings releases, things such as what we saw

1 here, which I think is terrific.

2 I just don't know if you have time to do
3 everything. If you have time to do that and consider it, I
4 wouldn't object to it. I don't think it is going to
5 necessarily lead you to a breakthrough conclusion.

6 If you have a limit on your time, I would drop that
7 item real quick and spend the same amount of time figuring
8 out how to promote the notion of what we just saw. I think
9 the value of that is just light years ahead of what you will
10 come up with in pursuing that executive summary reporting.

11 CHAIRMAN POZEN: Linda?

12 MS. GRIGGS: I just had an observation. There is a
13 recommendation in the SEC's MD&A interpretative release that
14 the MD&A have an executive summary. In some respects, the
15 content of the executive summary you are considering is
16 somewhat duplicative.

17 It may well be that the better place for the
18 executive summary is not in front of the MD&A. Some people
19 have wonderful ones that actually present a lot of the stuff
20 that you have suggested. Maybe it is moving that to the
21 beginning of the 10-K so that people at the outset gets what
22 is now presented often in MD&A. You might look at the MD&A.

23 CHAIRMAN POZEN: That's an excellent suggestion and
24 maybe a way to not have to re-invent the wheel but just build
25 on something there and move it to a different spot.

1 Chris?

2 MR. LIDDELL: Yes, I was just going to respond.
3 Distinguish between an executive summary and a separate
4 document, which is a summary in your report. We are not
5 talking about the latter. We are talking about the former.

6 It was pretty much along the lines you suggested,
7 that we have something that is a summary of all information
8 but sits at the front and helps people navigate to the
9 detailed information.

10 CHAIRMAN POZEN: Just to make sure that we have
11 staff at this stage -- I don't believe it mentions the
12 interpretative point that Linda did, that we integrate this
13 -- get a paragraph on that so that we make sure to include
14 that as one way to get quickly there.

15 Yes, John?

16 MR. WHITE: The other document you see often is the
17 president's letter, just as another document that sometimes
18 is at the front that covers more information.

19 MR. DIERMEIER: You mean the quarterly president's
20 letter? Excellent.

21 CHAIRMAN POZEN: There is a bit of cynicism on
22 that.

23 MR. COOK: Jeff, this is not an order of priority
24 for your group, these four items.

25 CHAIRMAN POZEN: I think we appreciate the work

1 done by Subcommittee 4. I think we have two very actionable
2 proposals on rolling out XBRL in a phase in and exploring
3 these questions, and this very exciting presentation by
4 Microsoft on what can be done with an overview on the web and
5 the genius of hyperlinks to let you go there.

6 I think that is good. We will be considering
7 others. I'd like to move now to Subcommittee 3. This
8 material begins on --

9 MR. KROEKER: Bob, do you want to vote on the
10 proposals after each section or at the end?

11 CHAIRMAN POZEN: I guess we can vote on the
12 proposals now. I thought we did. We voted on the first one,
13 XBRL. Let's have a formal vote on these second set of
14 proposals.

15 All those in favor.

16 (Show of hands.)

17 CHAIRMAN POZEN: Anyone against?

18 (No response.)

19 MS. GRIGGS: Can I just make a comment?

20 CHAIRMAN POZEN: Yes.

21 MS. GRIGGS: On the KPI one, I just would urge you
22 to look also at the requirements for reconciliation in Reg G
23 and Item 10 of S-K at the same time to make sure those
24 aren't hindrances, that they are consistent, whatever.

25 CHAIRMAN POZEN: Good. Amy, it's not just the

1 electronic questions, but I do think if you are asking about
2 what could hang up, maybe non-GAAP financials.

3 I think Subcommittee 3, you are at chapter four. I
4 think the proposals begin on page 58. Mike, I'll turn it
5 over to you.

6 SUBCOMMITTEE 3 - AUDIT PROCESS AND COMPLIANCE

7 MR. COOK: Thank you, Bob. Greg and Linda are
8 members of this Subcommittee. Ed is on the phone or is going
9 to join at a later time. Ed? Ed Nusbaum is also a member of
10 the Subcommittee and will be joining this meeting in part
11 perhaps on the telephone.

12 We have had wonderful support and input from lots
13 and lots of different folks. I will not try to name them all
14 in the interest of time and not showing you how my memory is
15 failing.

16 If I didn't say something to Bert Fox, who is right
17 there, who has been the quarterback of our staff support
18 team, I would be greatly remiss.

19 Bert has done a spectacular job for us while he has
20 been dealing with moving, additions to the family, lots of
21 other things happening in his life, and he's done a great
22 job. Bert, thank you very, very much for that.

23 We have two developed proposals. One is a subject
24 that we covered in some detail at the last meeting. I will
25 try to just update that and then take your questions and

1 comments. That deals with the issue of errors and the
2 correction of errors, restatements and the topic of
3 materiality as it relates to restatements and errors.

4 Separately, we have a developed proposal on the
5 issue of a judgment framework or a framework for the
6 application of judgment, which we believe is far enough along
7 for consideration by the full Committee. We recognize that
8 it has value and importance to two other Subcommittees as
9 well.

10 We have coordinated with Subcommittees 1 and 2 who
11 see this as being important to what they are doing with
12 respect to addressing overall complexity in standard setting,
13 and we believe we have something that is responsive to the
14 needs of those groups as well.

15 With respect to restatements, errors, materiality,
16 how to correct and how to disclose, that is the principal
17 thrust of the first developed proposal, we did add one thing.

18 We sort of didn't say this but it was something
19 that was pretty inherent in our thinking, but it did
20 certainly merit being said, and that is that we are not here
21 to do away with restatements per se.

22 We would like to think that a lot of things that
23 are happening, including work that is being done not so much
24 in our Subcommittee but in other Subcommittees will help
25 reduce the number of errors, which will in turn reduce the

1 number of restatements.

2 We are not here just to do away with restatements
3 as an objective, but to start out with the notion that
4 everybody who is involved in this process, from the standard
5 setters to the regulators to the firms and everyone else who
6 can influence the outcome, should do all they can to help
7 reduce the number of errors in financial statements, and that
8 will be the most significant enhancement of financial
9 reporting.

10 We believe, based on what we have seen, that in
11 fact the number of errors is declining. That is as a result
12 of lots of different things, including the attention to
13 internal control, the attention to financial reporting
14 through Sarbanes-Oxley, lots of different things going on
15 that are improving the quality of financial reporting.

16 We think we are moving in that direction. We think
17 the adoption of recommendations that are forthcoming from our
18 own Committee can help move that even further as we go
19 forward.

20 We have recommendations from Subcommittee 1. I
21 won't try to preempt them. They deal with the issue of
22 avoidable complexity, and to the extent that we can eliminate
23 avoidable complexity, with that, we believe, will reduce
24 errors and in turn reduce restatements.

25 Likewise, Subcommittee 2 has a number of

1 suggestions including the notion of post-issuance of a
2 standard and diversity in practice, and not having a right
3 and a wrong, where the right is right and the wrong is a
4 restatement, that notion put into practice would also reduce
5 the number of errors and restatements.

6 We think there are a lot of things happening in
7 this regard that are positive and supportive of the overall
8 objective.

9 What we are seeking to add to that is what we would
10 do with respect to being able to eliminate unnecessary
11 restatements given that the errors are still going to exist
12 in some instances.

13 What we are talking about is not eliminating all
14 errors, but what we do when an error in fact does take place,
15 when it is found that there is a difference in previously
16 issued financial statements which may or may not be material
17 that requires evaluation as to whether or not a restatement
18 might be required.

19 That is what we are talking about here. We think
20 the principal recommendation that will enable a reduction of
21 unnecessary restatement is improved current guidance, more
22 comprehensive guidance on materiality.

23 A number of different aspects of that, including
24 the notion that materiality, which it always has been, needs
25 to be clearly expressed in terms of the needs of the

1 investor, the reasonable investor perspective, not the
2 perspective of lots of other folks, all of whom would stand
3 between the financial reporting process and that ultimate
4 investor, but rather, standing in the shoes of the investor
5 looking at the total mix of information that goes to the
6 investor community, and asking whether the error or the
7 difference in the information would materially alter, would
8 substantially alter the mix of information or the conclusions
9 of investors with respect to it.

10 We have signed up for the no bright lines club. We
11 had some bright lines -- we didn't intend them to be quite as
12 bright as they were taken to be -- we had some quantitative
13 tests in our previous report. We have eliminated those here,
14 where we had made references to the five percent threshold, a
15 ten percent threshold.

16 We were reminded that lots of folks have told us
17 that bright lines don't work, why are you trying to use them.
18 We have taken a step back from there.

19 We still have the notion here of a sliding scale in
20 making judgments about materiality. The smaller an item is,
21 the more compelling the qualitative considerations need to be
22 before it would be deemed to be material. The larger the
23 item, the more compelling the qualitative factors would need
24 to be on the other side if you were to conclude that it is
25 not material. The concept is still here, but the bright

1 lines are not.

2 We have retained our notion, which we feel strongly
3 about, that we need to in the guidance be sure that we make
4 what is currently SAB 99 -- and it has another name which I
5 don't recall -- two way.

6 It is an excellent one way street, but we need two
7 way traffic here. It is an excellent document that deals
8 with the issue of how things which are qualitatively material
9 may be material even if not quantitatively material. We need
10 to take the other side of that in the guidance and be sure
11 that we have the balance of those two.

12 We have a suggestion for amendment of SAB 108 in
13 terms of believing that we should not have restatements of
14 previously issued financial information for items that are
15 not material and if the cumulative effect kind of approach
16 that is recognized in SAB 108 causes restatements of
17 immaterial items, that those should be dealt with in the
18 current financial reporting, not by restating a lot of prior
19 periods for things which are not material to any one of those
20 periods.

21 We have stuck with our notion that APB 28, without
22 doubt, needs some current thinking and a current look,
23 reminding ourselves that probably APB 28 is older than most
24 of the people in this room, and things have changed rather
25 dramatically in interim financial reporting during that

1 intervening period, yet it is the only reigning guidance on
2 that subject, and we do need to take a fresh look at the
3 question of what is material to interim periods.

4 We have gotten a lot of input back and forth on the
5 notion of "Is an interim period a discrete period?". "Is an
6 interim period a component of an annual period but not a
7 discrete period?"

8 We have suggested that is really not the most
9 relevant question. The most relevant question here is what
10 is material information in the interim period to that
11 reasonable investor and how should that be evaluated and
12 looked at in the overall mix of information rather than
13 trying to debate to a conclusion, is it this or is it that.

14 That is reflected in the material that we have
15 here.

16 Key principles. Pretty much the same as what we
17 had. One that is very important is that all errors should be
18 corrected when they are discovered.

19 An exemption for de minimis errors, we are not
20 talking here about a cut-off issue which is consistent from
21 period to period and very minor in amount.

22 Also, we put in a notion to try to be practical
23 about that, that things may come up very late in a closing
24 process that are not material that are errors and we didn't
25 see any particular harm done, as long as they are corrected

1 in the next fiscal period, next quarter, next annual period,
2 whatever it might be, that this notion of carrying errors
3 forward or never fixing them or amortizing them over a period
4 not to exceed ten years or something of that kind just
5 doesn't make sense.

6 Errors ought to be fixed when they are identified,
7 and that is what we have suggested.

8 Restate prior financials only for material errors.
9 If you have an accumulation of immaterial amounts, which does
10 seem to be a fairly common type situation, fix them in the
11 current period, don't go back and restate a bunch of prior
12 periods, as would be required under present literature.

13 The final segment of our recommendation deals with
14 the issue of disclosure. We have heard a lot about the fact
15 that there are two aspects of disclosure as it relates to
16 restatements that are not meeting the needs of the
17 marketplace.

18 The first of those is that there is this dark
19 period when somebody announces that we have a problem and we
20 are going to have a restatement and then things just shut
21 down, and they shut down for an extended period of time,
22 because people are very reluctant to disclose information
23 that is uncertain, that is not verifiable in interim periods,
24 at interim points, until the ultimate outcome is known.

25 Strong feedback from the marketplace says we

1 really need some information here. You have to turn the
2 light on this dark period as best you can.

3 We do have a notion in here that says we do need
4 regulatory support as well to do that. People are reluctant
5 to go out with information that is not going to be as precise
6 and will in some instances turn out to be different from the
7 final outcome, and there needs to be regulatory support for
8 that to take place.

9 Finally, just the basic information about the
10 error, the nature, the impact, and the management response to
11 the error. What was it? Where did it come from? Why did it
12 happen? Not the "why" so much, but the description of the
13 error, and then what has been done by management to prevent a
14 recurrence of that in the future.

15 We think some enhanced disclosure about errors
16 which cause restatements which are material would be in order
17 and would be responsive to the marketplace as well.

18 That's the essence of what we have. Most of it,
19 you have seen before, heard about before. Some of it has
20 changed a bit.

21 Bob, I would say let's take that item and then we
22 will come to part two.

23 CHAIRMAN POZEN: I think there is a lot of work
24 that has been done here on materiality. It is a complicated
25 subject. I think there has been some real progress on this.

1 I'd like to solicit comments. Denny?

2 MR. BERESFORD: I certainly support the general
3 approach here. I guess I happen to be one of those who feel
4 that APB Opinion 28 is clearer on this than practice has
5 admitted.

6 Mike, in your verbal comments, you indicated that
7 APB 28 is an issue, and I thought you were saying basically
8 that should be re-visited. That doesn't seem to be what the
9 report says.

10 It seems to me that would be an issue, that there
11 is official literature on point, and some part of the process
12 ought to be either obviating it or changing it. It seems to
13 me it would be appropriate to change it, although I guess
14 this is one of many different things that Bob has on the
15 agenda for convergence and so forth.

16 The other thing, just sort of a completely
17 different point, on the dark period, at least a couple of
18 major restatements that I've been involved with were not as
19 simple as what I think the disclosure approach would call
20 for.

21 Sometimes you start with one particular known
22 issue, but when you begin an investigation, it turns out
23 there are a lot of other things.

24 It's a little troublesome, I think for people to
25 say we are looking at X and know they might end up with Y, Z,

1 and A, B, C and D along the way, and while you are giving
2 disclosure about X, the other things could be much more of a
3 problem at the end of the road.

4 I think some sort of interim disclosure is
5 appropriate, but I just think it is a little more complicated
6 than what we have in the draft right now.

7 MR. COOK: Denny, I think what we heard and what I
8 think the people we heard from would say is the couple that
9 you make reference to, I won't guess at them by name, but you
10 and I would not have any trouble knowing which ones you are
11 talking about are probably of a magnitude and of a nature
12 that they are not going to be substantially affected by
13 recommendations that we would make here, just knowing how
14 pervasive and how significant those situations were.

15 The feeling is there are a lot of these that are
16 not nearly that comprehensive, not nearly that pervasive,
17 that they are relatively isolated, that there are things that
18 could be said about what is being investigated and where it
19 stands and what people can rely on as opposed to just
20 throwing the cloud over everything that is out there and
21 leaving the cloud there for extended periods of time.

22 That is what we heard. I would think the ones you
23 are talking about, I believe, would probably not be subject
24 to alteration by this guidance.

25 MR. SIDWELL: You used the term when you talked

1 about materiality "about making the judgment based on the
2 impact of the total mix of information available to a
3 reasonable investor."

4 Have you thought about how you were defining
5 "reasonable investor" and what type of perspective, as you
6 try to accumulate that viewpoint, what is the perspective of
7 how a "reasonable investor" is defined?

8 CHAIRMAN POZEN: I'll jump in on that. I think we
9 are pretty much going on the conventional wisdom on that. I
10 think what we have added here is that when we are considering
11 whether to make a restatement, we are focusing on the needs
12 of the reasonable current investor.

13 I don't think we are trying to tackle what is
14 probably an untacklable problem, to define what is
15 reasonable. I think what we are trying to emphasize is it is
16 the current investor whose perspective may be different than
17 somebody two or three years ago, where it might have been
18 important then but it's no longer important.

19 MR. SIDWELL: About the different points at which
20 decisions were made by different groups of investors, so now
21 it is very much focused on the current investor.

22 MR. COOK: That is what is intended.

23 CHAIRMAN POZEN: Charles?

24 MR. HOLM: I had a similar point as David. I did
25 notice in this Subcommittee's work that in one place, I think

1 they used "reasonable investor," and another place, "current
2 investor." I think it is Subcommittee 2 that talks about
3 investors and other users.

4 I think some careful look at that would be useful.
5 As far as being "current investors," there can always be
6 prospective investors, people thinking about whether or not
7 to buy. Maybe it should be broader than just "current
8 investors."

9 The second issue, and this may apply more to
10 Subcommittee 2, but it's relevant here, too, should we
11 include creditors and regulators as well.

12 There has always been an issue there, for example,
13 that creditors and regulators can compel institutions to
14 provide additional information, so perhaps they are a little
15 bit different.

16 On the other hand, creditors and regulators very
17 much use this information. We certainly do at the Federal
18 Reserve. It is an important screening device, for example,
19 to decide whether to get more information.

20 I do think when we are looking at this issue both
21 in this Subcommittee and in Subcommittee 2 that we consider
22 also including creditors and regulators.

23 MS. GRIGGS: I think we felt that we needed to use
24 the definition that the courts have used for materiality
25 because after all, this is a legal judgment. If you look

1 carefully at our document, I think we have been very careful
2 to speak in terms of the materiality of an error, that it has
3 to be judged the way a court would, and that is the
4 reasonable investor who is looking at those financial
5 statements at that time.

6 When we speak about a restatement, we have been very
7 careful to talk about the fact that it is a judgment not on
8 whether or not the error is still material, we are not
9 questioning whether the error was material, we are
10 determining whether or not the financial statements should be
11 restated. That is a totally different judgment.

12 In the first instance, is the error material, and
13 if it is ten years ago, it may well be material because a
14 reasonable investor looking at those financial statements at
15 the time would have thought it was important that the
16 financials had been corrected or had shown the error the way
17 it was supposed to have been.

18 Today, we may not restate it because it has no
19 current relevance to an investor. That is the distinction we
20 were trying to make.

21 CHAIRMAN POZEN: Jeff?

22 MR. DIERMEIER: Mike, are we talking about 4.1 and
23 4.2?

24 MR. COOK: Yes, we are.

25 MR. DIERMEIER: On your third bullet point,

1 quantitatively significant error, use of the word
2 "significant" has significance and maybe you mean
3 quantitatively large error. If it's significant, then it
4 seems to me it is material.

5 MR. COOK: Yes; that's very good.

6 MR. DIERMEIER: On 4.2, obviously, who knows, maybe
7 even XBRL can provide part of the answer, and I'm sure Greg
8 has thought about this a lot in terms of recommendations.

9 A lot of us investors when we are looking at
10 things, of course, we are calculating growth rates. I'm sure
11 you contemplated that. If you are not restating, obviously
12 certain growth rates can be made, but they really do not
13 calculate, you are way off.

14 I'm not presuming any precision here because we all
15 know investing is far from a precise art in that regard.

16 You had to think about how that might affect the
17 way people would actually look at certain items and calculate
18 growth rates and make comparisons that way.

19 How have you handled that here? Could XBRL, the
20 data, be corrected without there being a restatement?

21 MR. COOK: The latter point, Jeff, I don't think we
22 thought about, or at least I don't recall. The point about
23 growth rates and trends is contemplated here by saying some
24 things are going to be more material because of the things
25 that are influenced by them where other items perhaps will

1 not, if it is a one time item.

2 If it doesn't affect growth rates, if it doesn't
3 affect trends and earnings, perhaps it is less likely to be
4 material, without regard to its size at that point.

5 The XBRL point is an interesting one. I don't
6 think we have even thought about it.

7 CHAIRMAN POZEN: I'm not sure XBRL solves the
8 problem because you still have to decide whether you are
9 going to have a restatement or not, whether it's in the form
10 of XBRL or not.

11 I think, Jeff, this was not intended to be a
12 comprehensive list of factors. It was trying to be sort of
13 some illustrative factors that might come into play.

14 MR. DIERMEIER: What I heard Mike say is an
15 important growth rate could be considered material.

16 CHAIRMAN POZEN: Sure.

17 MR. DIERMEIER: Thank you. Scott?

18 MR. EVANS: I wanted to congratulate the group on
19 these recommendations. I think you really do begin to
20 achieve the perspective of a reasonable investor when you put
21 this through, and I think the proposals that you have for
22 improving communication during the dark period are excellent,
23 and it will definitely help investors, even in circumstances
24 where the company's discovery process has a couple of
25 different stages.

1 If the company attempts to keep investors informed,
2 that will facilitate the process and serve everybody's
3 interest.

4 The fact that you are recognizing the preeminence
5 of the reasonable investor and tying in with legal
6 precedence, I think, wraps everything in a nice package.

7 I do have some concerns about the whole restatement
8 process. From an investor's perspective, and Jeff was
9 talking about this, the investor is not concerned about a lot
10 of restatements to the extent that the restatements provide
11 the investor with the information.

12 Auditors and preparers are very concerned about
13 restatements because they are considered errors, and there
14 are liabilities that come along with that, there is
15 disruption that comes along with that.

16 The challenge really is to find a way to get the
17 information out there that comes with restatements. The nice
18 thing about restatements is it causes you to go back and
19 recast everything, particularly the sophisticated retail
20 investor can understand the impact, and only a sophisticated
21 investor would be able to follow the complex footnotes that I
22 think might result from the procedures that you have laid out
23 here.

24 I wonder if the challenge isn't to find a way to go
25 at the liability issue, the connection between restatement

1 and error, and not try to limit the information that is going
2 to investors from restatements themselves.

3 I think as we put this out to comment, we will find
4 that investors are desirous of continuing to get the
5 information that comes with restatements today.

6 MR. COOK: I think it is a good point. I think one
7 of the things we would hope would be a product of this would
8 be that investors will get important information, they will
9 get restatements, but it won't be cluttered with a lot of
10 other things that are really not of importance to them and a
11 careful analysis will enable people to make that distinction.

12 This is not to suggest that information would not
13 be recast because if it is a material error, our basic
14 premise here is that you are going to have to restate and
15 recast that prior information, if that hurdle has been
16 crossed.

17 I was trying to make that distinction. Even if
18 there are material errors -- not material errors -- errors
19 which are -- let's call them "large," to go back to the term
20 "not significant" -- there will be disclosure when they are
21 fixed in the current financial statements. It will just not
22 require amendment of all prior filings.

23 Your point about how clear will that disclosure be
24 and how easy will it be defined is the challenge.

25 MR. EVANS: That is precisely the scene I was

1 talking about. The trick of not going back and recasting
2 prior information sort of shuts out the retail investor, the
3 sophisticated investor, anybody but the full time security
4 analyst from really understanding the dimensions, and being
5 able to forecast growth, trends and so forth.

6 I wonder if there is not a way to get that
7 information out there without all of the baggage that comes
8 with restatements and recasting, the way the accounting and
9 legal rules work.

10 MR. JONAS: Scott, I agree with much of your
11 observation. The two paragraphs at the top of page 56 was
12 our perhaps inadequate attempt at capturing much of the point
13 that you make.

14 I just want to observe that we have seen in our
15 practice a lot of restatements that we think just don't
16 matter to us. It is costly for us to have to deal with that.

17 Even though the company has gone through all the
18 trouble and pain and cost of restating themselves, now they
19 give us recast data, we have to understand why it changed,
20 evaluate whether we think it is significant, recast the data
21 in our database, run all of our models again and see if it
22 mattered. A lot of times, it just plain didn't.

23 If we can reduce the stuff that doesn't matter, I
24 think the user, too, is helped.

25 CHAIRMAN POZEN: More comments that people want to

1 make?

2 (No response.)

3 I want to focus people on a few things. One is
4 that I guess we will have to consider whether APB 28 needs to
5 be modified. It's a good point. It may have to be, or
6 interpreted or something like that.

7 MR. KROEKER: We cover that a little in footnote
8 17, but we can be clearer.

9 MR. COOK: What we are really saying here is maybe
10 there are aspects of this and maybe the majority of it is
11 fine, but it's been around for a long, long time. The world
12 has changed a lot.

13 Interim reporting and the importance given to
14 interim reports has changed dramatically.

15 This is a time to take a good fresh look as part of
16 this overall review of materiality. It is not to say that
17 there will not be parts that will be just fine and carried
18 forward in the current guidance, to Denny's point.

19 It was intended that we would say that. We do need
20 to tighten it up a little bit.

21 CHAIRMAN POZEN: I guess footnote 17 does give you
22 the link -- I'm sorry, I didn't catch that footnote.

23 Second of all, I think Linda is very persuasive on
24 her point about we have to stay with the court definition of
25 "reasonable investor." For materiality, it is a different

1 question about whether you need to have a material
2 restatement.

3 The third point, which I think is especially good,
4 about the recommendations, it is a real effort to correct
5 errors even if they are not material, to get that out there,
6 and as many people said, disclosure.

7 The one point I just want to make sure that
8 everybody is comfortable with, since there was some
9 discussion last time, is the treatment of errors in interim
10 financial statements.

11 There is sort of an elaborate, I think, and
12 intelligently worked out approach to that. I want to make
13 sure that people feel comfortable with that. This is sort of
14 neither to say always nor never is interim, but sort of look
15 at sort of a broader approach to interim, so it's sort of a
16 middle ground on interim's, and I just want to make sure that
17 people are comfortable with that.

18 If I don't hear anything else, I will assume --

19 MR. McCLAMMY: I thought it was a significant
20 improvement from where we were in the last one, particular on
21 the interim.

22 I did decide I would like to make a comment on the
23 overall as well, and I think the Subcommittee has made
24 significant progress since the last meeting and the last
25 draft. I think it is a very major step improvement from

1 current practice, that we should head down -- particularly,
2 as someone mentioned before on the dark period, I think Joe
3 Grundfest said it well at the last meeting, that we take
4 information away from investors probably when they need it
5 the most.

6 I think that is a very good recommendation.

7 CHAIRMAN POZEN: That is in part an answer to your
8 question, Scott. Once you decide to have the full
9 restatement, then you may get the information, but you may
10 get it a year later.

11 I'm not sure we are in that good a position to
12 change the liability, court liability, for restatements.
13 Interesting idea. I think it is sort of beyond our intent.

14 Anyone else? I agree, Ed. I think this is really
15 very, very good work. The Subcommittee has really bit the
16 bullet and really come to grips with some very tough
17 questions on materiality and came out with some quite
18 intelligent decisions.

19 Jim?

20 MR. QUIGLEY: Just to make sure that I understand
21 what is being said with respect to the interim periods, where
22 we believe we have "found" some healthy mid-ground. We are
23 not describing that we believe that a quarter is a discrete
24 period. We are trying to find a way to thread that needle.
25 It's not a component of a year, but we are also not saying

1 take whatever quantitative measures to the extent that people
2 use quantitative measures in coming to conclusions. We are not
3 saying take those measures and divide them by four as you
4 apply it to the quarter. That is not what is being said.

5 MR. BERESFORD: That was my concern. I happen to
6 think that APB 28 is clear with respect to the integral
7 approach versus the discrete approach. That is not the way
8 it is being applied in practice with respect to SEC and
9 accounting firms and so forth.

10 It seems to me we ought to go back and amend or
11 interpret or something, do something with APB-28 as opposed
12 to just having some document on the street that somehow
13 ignores the existing literature and comes up with, as you
14 say, a threading a needle type of different approach.

15 CHAIRMAN POZEN: We will see if we can come up with
16 something relatively specific on that and then run it by you,
17 Denny, in terms of how exactly that will be stated.

18 Bob?

19 MR. HERZ: When I read all this and not using the
20 word "materiality" or "material," it seemed to me the basic
21 principle was correct things when you think from a reasonable
22 investor's point of view it would matter.

23 CHAIRMAN POZEN: Current, but have a restatement if
24 it is really important to current investors.

25 MR. HERZ: Correct. That was basically the set of

1 principles off of which to work without kind of trying to
2 argue, and then the question is that's an awful lot of
3 detail, how to operationalize that without kind of then
4 getting back into the box that we have been in.

5 CHAIRMAN POZEN: Jim?

6 MR. QUIGLEY: I just want to emphasize one
7 other point, and that is this will be a gigantic step forward
8 if in fact those two-thirds or 80 percent of the restatements
9 that we see today that investors don't care about and you are
10 only annoyed by, because you don't think there is any real
11 meaningful information that is coming and you don't like re-
12 running the models and nothing changes, if we get to the
13 point that we are no longer restating for those items, that's
14 a gigantic step forward.

15 The other point that I think we ought to at least
16 acknowledge, and I think the report does a nice job with it,
17 on the transparency point, to get at Scott's point, there
18 will be some interesting discussions when you are preparing
19 those financial statements and you conclude we are not going
20 to restate because this out of period adjustment is not
21 material, but we are going to be transparent about the fact
22 the current period includes an out of period adjustment.

23 It will just require significant judgment in coming
24 to the conclusion on how to most effectively communicate with
25 users and investors on those matters that you believe warrant

1 transparency but they are not so large that they require
2 restatement.

3 CHAIRMAN POZEN: That's an excellent transition to
4 our next subject of judgment. This is again a very big topic
5 that Subcommittee 3 has tackled. I think tackled in quite an
6 intelligent and thoughtful way.

7 I think we all know that the question of judgment
8 underlies so much of the various aspects of this Committee
9 and all the movements in financial accounting.

10 I think we should just take a vote, just to make
11 sure that Jim is happy that I'm doing this right. The
12 proposals on page 58, 4.1, and 4.2 on 59 and 60, and 64, that
13 we are in agreement with those, subject to the interims
14 being worked out with APB 28.

15 Everyone in agreement with that, please raise your
16 hand.

17 (Show of hands.)

18 CHAIRMAN POZEN: Anyone in disagreement?

19 (No response.)

20 CHAIRMAN POZEN: Now we get to professional
21 framework. There is a lot of good stuff that sets this up.
22 In the end, you get to pages 71 and 72, where we actually try
23 to bite the bullet and set out a framework.

24 I think one thing just to point out, a legal point,
25 Mike, the Committee basically said we would be okay if this

1 was a policy statement or a safe harbor. We are not sure as
2 a legal matter whether the Commission could just issue a safe
3 harbor in this respect, and we are not going to make that
4 decision.

5 We are trying to concentrate on the substance here,
6 and we will leave it to the legal beagles at the Commission
7 to decide whether this can be a safe harbor or not.

8 I think we are not going to try to -- we want this
9 to be an effective policy, and we are not going to get into
10 that issue.

11 With that preface, Mike, I'll give it over to you.

12 MR. COOK: Thank you, Bob. Just to that one point,
13 the most important thing from our perspective here is that we
14 establish an appropriate framework and that we implement the
15 framework.

16 There have been recommendations that we have
17 learned from some of the research we did, not in this area
18 particularly, but some pretty good recommendations in other
19 areas, which have been linked to safe harbors and have gone
20 down to defeat or demise because the safe harbors were not
21 doable or people weren't able to bring them to that level of
22 protection.

23 What we are really saying here is if we could have
24 a safe harbor, if this could be crafted as a safe harbor, and
25 that would require high level support from the Commission and

1 perhaps legislative response as well, not sure about that, if
2 that were the acceptable outcome and doable, terrific. We
3 would be all in favor of that.

4 If that is not achievable or perhaps not achievable
5 in the initial instance, we do not want the recommendation to
6 be just carrying that one means of implementation, the
7 alternative being the position statements and perhaps that
8 leading at an appropriate time to a safe harbor.

9 CHAIRMAN POZEN: I do think, Mike, as a general
10 matter, we have tried to stay away from legislative solutions
11 since we know that's a whole different ball game.

12 MR. COOK: Yes. This one is just beyond our
13 capability to sort out all the what might be done's and who
14 has the authority to do what's, but the concept of the
15 judgment framework is what is most important to us, delivered
16 in the most effective manner to provide the environment and
17 protection that we are seeking to achieve.

18 To comment a little bit on what it is and what it
19 isn't, and a lot of the descriptive material here, I think,
20 is quite easy to follow. I won't repeat it. It wouldn't add
21 anything if I did.

22 This is intended to be a judgment framework for
23 preparers and auditors for the purpose of making judgments with
24 respect to the application of generally accepted accounting
25 principles, accounting decisions, estimates, judgments,

1 things that go into the preparation of financial statements.

2 Separate from this, and referred to here, we think
3 it would be a good thing for there to be a judgment framework
4 for auditors to govern or to guide how they conduct audits.
5 How they set the scope of their work and the documentation
6 they would obtain.

7 That is the purview of the PCAOB. We have a
8 recommendation here that the PCAOB take on that issue and
9 make it consistent to the extent that consistency is
10 achievable with the concepts of what we have here.

11 What we have here is a role for the auditors, as
12 the auditors play a role in challenging through the audit
13 process, the application of generally accepted accounting
14 principles, estimates, judgments, and so on, but not how
15 audits are conducted. That is not intended to be covered by
16 this judgment framework.

17 We also suggest that this would be an appropriate
18 framework for regulators and others to look to in overseeing
19 and challenging judgments that have been made. That is one
20 of the intended outcomes of this, a respect for judgments
21 that have been made in an appropriate way and in an
22 appropriate framework. We would obviously be addressing this
23 to that group as well.

24 One of the things this is not intended to do, so
25 it's quite clear, this is not intended to put up any stone

1 walls between any groups for the purpose of doing what they
2 need to do to challenge and to participate in the application
3 of the framework.

4 This is not to say that if somebody can prove they
5 did A, B, C and D, somebody else can't ask any questions,
6 somebody else can't challenge the judgment that comes out of
7 this.

8 We believe auditors should be able to challenge all
9 judgments that the preparers make that are material to the
10 financial reporting process as part of their work. Hopefully,
11 they would be in the process of the application of the judgment
12 framework by the preparers and it'd be a collaborative process.

13 Nobody is suggesting that anybody's rights or
14 responsibilities have been taken away, and similarly, we are
15 not suggesting that the regulators, the overseer's, do not have
16 the right to challenge judgments that have been made just
17 because somebody can hold up the framework and say we did
18 all these things.

19 We would hope, however, that the environment in
20 which those judgments would be challenged would carry with it
21 this level of respect for those judgments if they have been
22 made pursuant to the framework suggested here, which kind of
23 says you know, somebody is entitled to the benefit of a doubt
24 if they in fact have done the things the way they are done
25 here. You are not entitled to make wrong judgments solely

1 because you followed a set of procedures.

2 You are entitled to the benefit of a doubt, and
3 some of the commentary that we have in here about hindsight,
4 we will welcome any thoughts you have about that.

5 It is also intended to say that these judgments are
6 made, the outcome of these decisions are made in a very
7 constrained time frame. People have to use the best
8 information that is available to them in January and February
9 to make a judgment about something that has to be reported on
10 a timely basis.

11 There will be a lot more information available six
12 months, 18 months later to those who might challenge those
13 judgments, and we believe the people who do challenge those
14 judgments should do so on the basis of the reasonable
15 information that was available, reasonably available, at the
16 time the judgment was made, not the fact that gee, somebody
17 went bankrupt 18 months later and you should have known they
18 were going to go bankrupt and written off the receivable at
19 the time those financial statements were prepared.

20 We hope we have captured that concept here, that
21 timeliness and hindsight need to be approached also in a
22 respectful manner.

23 That is some of the most important things. One of
24 the things we have added here because we had talked about
25 this at the last meeting and we have gotten some input,

1 people would like us, through the judgment framework, to make
2 GAAP something that GAAP is not.

3 GAAP is not economic substance. We just have to
4 accept that. There are many areas of GAAP where the
5 application of generally accepted accounting principles does
6 not necessarily produce an answer which conforms to the
7 economic substance of a transaction. There is no such
8 requirement today.

9 There is a form versus substance or substance
10 versus form requirement, but this is not the place for us to
11 apply or implement such a standard.

12 Similarly, there is no requirement for
13 preferability in choosing among alternatives. The suggestion
14 was given to us that one of the great things we could do with
15 this framework would be to say in applying the framework, you
16 must choose the best accounting principle for whatever the
17 particular item might be as it relates to this company.

18 That is not a requirement today. There are an
19 array of alternatives in any one of a number of areas, some
20 of which we pointed out by example in here. You have to use
21 the preferable method if you are going to change from one of
22 those acceptable alternatives to another, but there is
23 nothing to compel somebody to stop using an acceptable
24 alternative and move to the preferable alternative in the
25 absence of a change.

1 We can't accomplish that nor should we try to
2 accomplish that through this framework by imposing standards
3 of preferability and economic substance. We think it is a
4 great thing to do.

5 In other parts of the work of this Committee, there
6 are suggestions that optimal standards should seek economic
7 substance. They should seek the best answer in a particular
8 circumstance.

9 We are suggesting here this framework can be
10 applied to GAAP as GAAP is today. That would allow the
11 continuation of perhaps a less preferable alternative, as
12 long as it's an acceptable alternative, and accounting for
13 things such as leases, pensions, and I won't bore you with
14 the rest of the list, which some folks would say are not
15 reflective of economic substance.

16 If you impose an economic substance, you are going
17 to change GAAP, and we can't change GAAP through this
18 process.

19 That has been added. Any comments you have on that
20 section, of course, we would welcome them.

21 The notion of the framework is that it is a careful
22 process. It's a timely process. It is a thoughtful analysis
23 of alternatives by people who have the right levels of
24 experience and expertise. You have to have the right people
25 involved to do critical analysis. It has to be done in good

1 faith.

2 It has to be done in terms of a legitimate weighing
3 of alternatives, not just show me where it says I can't do
4 this kind of an approach, but whether let's look at what the
5 choices are and try to find the ones that are best for a
6 particular circumstance.

7 Timeliness is important. Time spent is important.
8 This is not something you do in five minutes the day before
9 the report goes out. This is something that needs careful
10 and thoughtful consideration.

11 Consultation with experts including the auditors,
12 whom we believe to be an important part of this, and we would
13 like this hopefully to continue to dissuade the notion that
14 there is some separation between the auditors and the preparers
15 in finding the best answers in the area of accounting and
16 estimations and judgments, that they would be working
17 together, and one doesn't have to go do this and not talk to
18 the other one, and then turn it over to the other one for the
19 other one to come in and decide whether it was done right or
20 not.

21 This is intended to be an interactive and
22 collaborative process, and we hope that this would say that.

23 Contemporary documentation, and then disclosure, we
24 have some inputs that said maybe we should say that if
25 something is subject to this framework, it ought to

1 automatically be disclosed.

2 Our view was gee, we ought to let the existing
3 disclosure framework continue to be the appropriate framework
4 for that. Many of these things will be disclosed either in
5 the financial statements, in the MD&A, under the critical
6 policies, estimates and judgments.

7 For us to seek to impose a disclosure standard or
8 recommend to someone else that they impose a disclosure
9 standard solely because the framework that has been applied
10 didn't seem like an appropriate answer, so we have not
11 suggested that.

12 That is what we have in mind. We believe, Bob,
13 this is important, as indicated in other sections, to moving
14 from a rules based system to a principles based system. We
15 have to change this environment of fear of being second
16 guessed and I need more rules so I can be sure I can prove
17 that I made the right decision as opposed to creating an
18 environment where people recognize that judgment needs to be
19 applied.

20 It will lead to conclusions which are not always
21 the same for every person, and it will be a more constructive
22 environment for financial reporting than exists today.

23 CHAIRMAN POZEN: Thank you for that excellent
24 summary. Moving toward a more principles based system since we
25 are not eliminating rules. A different mixture.

1 Con?

2 MR. HEWITT: I think I know the answer to your
3 questions, Michael, I just wanted to be sure the way it is
4 worded here, that you are asking the Commission to develop a
5 professional judgment framework and consider safe harbor
6 areas that could be applied to that framework.

7 We kind of looked at safe harbors in AS5, and we are
8 somewhat limited, but that is a legal question more than
9 anything else, on something like this.

10 Thirdly, this would pertain to preparers and auditors
11 both? Is that what your committee felt? Or it just pertains
12 to auditors only and not preparers in terms of a professional
13 judgment framework in the chief financial officer's
14 department?

15 MR. COOK: It would be our judgment that this
16 should apply to preparer's and auditors in the process of
17 financial reporting. There is a separate framework suggested
18 for auditors for the purpose of conducting their audits, but
19 that should parallel this, but it is not covered by it.

20 MR. HEWITT: You do include the documentation phase
21 of this, which is important. PCAOB has AS3 which pertains to
22 documentation. I don't know if that particular standard
23 would have to be changed or anything else. That becomes a
24 problem for their inspectors and so forth in the process.

25 CHAIRMAN POZEN: I think our thinking was here that

1 dividing the presentation of financial statements, of which
2 this would apply to both management and auditors, but that's
3 why there was a separate recommendation on the audit process
4 because we realized there are some different curly cue's
5 there, and would have to be dealt with.

6 I think also to answer your question, we are asking
7 the Commission to issue a policy statement, whether it's a
8 safe harbor or not we leave to the legal issues and political
9 issues.

10 We want a statement that would be able to be relied
11 on so that it would be out there. We gave a few examples
12 that the Commission has done in the past.

13 The exact form of this statement or legal status, I
14 guess we are not trying to get hung up on, but we do want a
15 public statement that is issued.

16 Bob?

17 MR. HERZ: I understand and I think I agree with
18 the idea that there should not be some kind of test on some
19 kind of true North of preferability or economic substance or
20 whatever.

21 I was wondering whether in the framework here there
22 might be room in an explicit way, like we are doing with
23 materiality, to talk about which of the alternatives in the
24 viewpoint of the preparer and the auditor would achieve better
25 communication to the investor, the reasonable investor.

1 I didn't read those words actually explicitly in
2 there.

3 MR. JONAS: We cleverly buried them, Bob.

4 (Laughter.)

5 MR. JONAS: It's in the judgment framework, item E
6 was our attempt of trying to capture exactly your point,
7 where when picking among reasonable alternatives, look to the
8 information needs of users to help drive that pick. That was
9 our attempt.

10 CHAIRMAN POZEN: I think F is also another factor
11 that is relevant. Scott?

12 MR. EVANS: When you are working on the language
13 there, I think one of the things that is missing that may be
14 implicit, and we talk about reasonable judgment in our
15 Subcommittee's paper, we explicitly mention it, when an
16 investor is in a position where reasonable judgment is being
17 deployed differently by different interpreters, and the
18 outgrowth of it is decisions and disclosures that are not
19 comparable with one another, there's a problem.

20 It's a question of degree. There is only so much
21 incomparability that can be sustained before the investor
22 needs are no longer served.

23 I think I would suggest stronger language in here
24 about the need to assure reasonable comparability in the use
25 of these judgments.

1 The other thing, a more general statement, I think
2 the Subcommittee has done an excellent job of putting
3 together a framework for an optimal environment where there
4 is good faith by all parties, and auditors and preparers are
5 doing their level best to interpret the standards from the
6 spirit of the standard, and not trying to exploit the edges
7 of the standard, to get a particular accounting treatment.

8 Where auditors are clearly independent and serving
9 their gatekeeper function, and the spirit of good faith
10 prevails, and you assume that as a back drop in the briefing
11 that you put together, and I think it is excellent.

12 It is very different than the environment we have
13 today which rather than presuming good faith, as many people
14 said, presumes mal-intent.

15 We have all these bright lines and everything and
16 sort of presuming mal-intent and trying to make sure that we
17 can be sure mal-intent does not exist.

18 I would be really interested in the comments that
19 come from the investor users on this. To me, we are not yet
20 to the environment where we can just presume good faith. At
21 best, we are at trust but verify type of environment. You
22 would have to have some sort of mechanism if we are going to
23 have the SEC giving people room for good judgment, some
24 evidence to show investors, to verify that we are truly
25 trying to interpret the spirit of the standard.

1 CHAIRMAN POZEN: I just want to point out that the
2 phrase "good faith" is in the standard. It would have to be
3 shown. There is a footnote, footnote 22, that talks about
4 diversity in practice. We have hooks, but we can develop
5 them.

6 MR. EVANS: All I am doing is suggesting that these
7 are headline items rather than footnote items.

8 CHAIRMAN POZEN: Yes, thank you. Jim?

9 MR. QUIGLEY: I just want to emphasize some of the
10 points that Mike made. I agree completely with the comments
11 that were provided in terms of the collaboration and if in
12 fact the framework is intended to be a collaboration of
13 auditors and preparers in reaching judgments with respect to
14 financial statements, then I am totally on board with that.

15 The language that leads up to the framework puts
16 auditors in the same sentence as regulators and makes it
17 create the impression in my mind that what we were thinking
18 about is here's a framework for preparers and then those who
19 evaluate judgments made by preparers, including auditors,
20 would need to provide appropriate consideration of the
21 process that had been followed.

22 I think if we could in the paragraphs that precede
23 the framework take the word "auditor" out of the same
24 sentence that the word "regulator" is in, I think it will
25 help us.

1 The auditor has a responsibility for the financial
2 statements that is very different than the evaluative role
3 that the regulator plays. The auditor is required to form an
4 opinion on financial statements. The auditor is required to
5 do more than make inquiries about what happened as judgments
6 were made.

7 If your notion of the collaboration among preparers
8 and auditors in reaching judgments required to prepare
9 financial statements, if that could be made clear in the
10 report, I think it will be very helpful.

11 Solely for purposes of emphasis, I personally
12 believe that the defensive accounting and auditing that is
13 today part of our environment that has created the complex
14 system that I think we have, the only way we are going to
15 move away from that is with this notion of a judgment
16 framework that I think has to be sanctioned by the regulator,
17 and I think it has to be respected by the regulator.

18 I would strongly argue for safe harbor. I will
19 acknowledge I am not an attorney and I am not going to try to
20 practice that law. I do think we could have a safe harbor
21 from enforcement actions from the Commission perhaps, and
22 then as we get that, we will start to build up some case law
23 that could perhaps help us from a litigation environment even
24 short of the legislation that might otherwise be required.

25 I think this is the most important part of the

1 entire report. I think this is what has the potential of
2 changing the behavior in such a way that we can get away
3 from the complex system and all of the rules and the bright
4 lines and the defensive accounting and auditing that has
5 defined who we are.

6 I certainly hope that we won't find one or two
7 things to disagree with and then decide we can't go forward
8 with this. This perhaps is an overstatement but I think we
9 might be wasting our time with our report if we can't have
10 something like this.

11 CHAIRMAN POZEN: That is one reason the group with
12 Greg, Linda and Ed really tried to get this proposal as fully
13 developed and as early as possible.

14 Mark?

15 MR. OLSON: This is a timely follow up to Jim's
16 comment and also on Mike's and Con's. As you can imagine, we
17 are not waiting for a report like this to look more carefully
18 at the whole subject of professional judgment because
19 implicit in the move from AS 2 to AS 5, we are having to look
20 at that judgment question in a much different way this year
21 than we have in previous years. That process is in place.

22 2008 will be a year where we are working in the
23 field with our inspectors and in determining the manner in
24 which we take a judgment into consideration. That is
25 implicit in the move from AS 2 to AS 5.

1 I would think that working with the SEC, if we were
2 to ask to come up with from our perspective and from our role
3 as you just defined it, our view on professional judgment, if
4 the comments come in and suggest that is appropriate, we do
5 not oppose any part of that being in this report.

6 CHAIRMAN POZEN: Thank you. I think we know AS 5
7 has a lot of judgment built in. What we are suggesting is it
8 would be extremely useful for the PCAOB as well to articulate
9 such a standard so that people could get more comfortable.

10 MR. OLSON: Again, in conjunction with the SEC, I
11 think there is a natural flow. You start out with the
12 accounting interpretation and then you go from there.

13 From our perspective, when we were looking at the
14 manner in which the audit is being conducted, how would we
15 look at it from our perspective, so there is the natural
16 flow.

17 CHAIRMAN POZEN: Right. Jeff?

18 MR. DIERMEIER: I want to follow up with what Scott
19 and Jim said. I think this is so important that it really
20 needs more air time in Chapter 1 and the introduction because
21 there is only a scant sentence or two that talks about the
22 litigious environment and things like that.

23 You don't want to wait until you get into the body
24 of the report to understand what the most important thing
25 that we might be tackling is.

1 CHAIRMAN POZEN: I just want to react that one of
2 the things -- I think it is almost a tactical question. We
3 have that in the beginning, how shall I put it, there are
4 those that think that the litigation environment is important
5 and there are those who don't. I think we want to sort of
6 say this is a good thing to do.

7 We just need to be careful about what context we
8 put it into.

9 MR. DIERMEIER: I agree. Like Jim says, if we
10 don't move in this direction, a lot of this other work may be
11 just for naught.

12 CHAIRMAN POZEN: I would agree with that. Bob?

13 MR. HERZ: I totally agree with those comments. It
14 does occur to me that it's the issue of we can change the
15 standards but will it actually change the behavior and how do
16 you change the behavior. That we may get in part from the
17 audit side of the Treasury committee's work, as to how do you
18 change the education, the training, all the support
19 mechanisms to actually change the behavior.

20 I think just changing the standards is a necessary
21 condition, but it's not a sufficient one to get to this
22 desired end result. I don't know whether it is worthy of us
23 mentioning also in here that there needs to be other things,
24 like what Mark is talking about, PCAOB, but that is only one,
25 I think, very small part of the whole thing.

1 It's almost like re-training the dog, so to speak.
2 I don't want to be pejorative, but we have been used to for
3 25 years of operating in a certain way.

4 CHAIRMAN POZEN: I did mention to Arthur Levitt
5 that this would be one of the areas of overlap, and I think
6 it is a good suggestion that we make sure to -- I guess
7 through Kristen -- to input what we are doing in this area as
8 well as restatements, so that it can be useful to that
9 exercise.

10 MS. JACONI: Members are, of course, aware of
11 what's happening here. We have Tim Flynn on the committee,
12 and I think the auditing firms, as Jim said, are very much
13 behind this framework, but the issue has come up.

14 CHAIRMAN POZEN: Peter?

15 MR. WALLISON: I just wanted to ask Mike about the
16 question of comparability. I see the issue of professional
17 judgment is having some effect on comparability. If auditors
18 or anyone else is making a professional judgment about how a
19 transaction should be treated and recorded, that judgment, by
20 definition, can be different from someone else's judgment.

21 Have you thought about that in any way and how does
22 that play into your recommendation?

23 MR. COOK: Greg wants to take the first shot, I'll
24 back him up.

25 MR. JONAS: Until the first sign of trouble; right?

1 (Laughter.)

2 MR. COOK: Then I'm out of here.

3 MR. JONAS: Peter, our attempt at trying to deal
4 exactly with the point you raise is in two places in the
5 framework. One is (g). I'm on page 72. One is item (g) and
6 the other is item (h).

7 MR. GOLDEN: It is also arguably within
8 Subcommittee 2 about the need to look if comparability is so
9 widespread after there is reasonable judgment, if there needs
10 to be some form of standard setting done to narrow that
11 diversity.

12 I think you have to look at that and what Greg said
13 as well at Subcommittee 2's recommendation to wait until
14 after the standard has been issued and then evaluate from a
15 user's perspective if there needs to be a standard set.

16 MR. JONAS: Linda reminded me that we also dealt
17 with that in the disclosure part of our thinking.

18 MR. SIDWELL: If I may, from the second subcommittee,
19 this is actually a huge and important part from our
20 perspective, particularly if you moved to more of a
21 principles/objective based set of standards. By definition,
22 you are probably going to have more diversity at least
23 initially.

24 We think it is actually important that there is a
25 very active feedback loop between Con, Corp Fin, the

1 professional users, where there is active monitoring of what
2 is going on in practice to understand whether diversity
3 should be reduced in practice.

4 We actually for that reason in a number of our
5 recommendations when a new standard is issued feel it is
6 important to acknowledge that is going to be the case and
7 secondly, that we believe it is very important to have a
8 formal post-implementation review of some time defined
9 according to how important each of the new standards are, to
10 explicitly do that.

11 We think if you are going to get to the point where
12 there are fewer people involved in interpreting standards to
13 the extent it creates, if you like, an informal GAAP, by
14 definition, you need to have that feedback loop with the
15 regulators, with the FASB, that if the FASB says this is a
16 level of different practice, a greater level of different
17 practice than we can accept, that really should be the focal
18 point for deciding how now do you act to reduce that level of
19 diversity.

20 MR. DIERMEIER: David and Mike, I know you tried to
21 finesse economic substance, but to the degree that the
22 conformity would occur around economic substance, and I know
23 you are trying to work through the GAAP issues and put GAAP
24 first from that standpoint, that would be the rallying
25 principle.

1 CHAIRMAN POZEN: I guess we would have to see
2 how --

3 MR. DIERMEIER: From the user perspective.

4 CHAIRMAN POZEN: How geared the standard was to
5 economic substance. I already know Mike's answer to that.

6 I do think David's point is very important. In
7 Subcommittee 2, we have two, I think, important proposals.

8 One is for a transition period for new standards in
9 which we sort out the interpretative guidance, and one of the
10 specific goals of that is to see whether there is too much
11 diversity of practice, and if there is, we need to close it
12 up.

13 Second of all, we are talking about a periodic
14 post-effective sort of look at important standards, again,
15 one of the key objectives would be to see whether there has
16 been too much, what we would think of as too much diversity
17 of practice.

18 I think we have an inherent tension on the one hand
19 to the extent that we want to promote more principles based
20 and less rules. We have to accept more judgment. It's a
21 good thing. I think all of us know the cost of just having
22 mechanical judgment, mechanical applications and judgment.

23 We are trying to build in mechanisms to deal with
24 this comparability issue at two stages. I guess we will have
25 to see how that works.

1 MR. COOK: One point, Bob. I just want to be the
2 back board here, Jeff, and just bounce this one back to you.
3 I really think it is beyond in any reasonable time frame, the
4 ability to change GAAP, to change basic financial reporting
5 to deal with economic substance.

6 On the other hand, I think there is a great deal of
7 financial reporting around matters of economic substance or
8 reporting in the financial reporting package around matters
9 of economic substance that are in some of the areas that you
10 are going to be addressing.

11 Performance metrics. Business. Key indicators.
12 Those are the economic substance of the business.

13 I was thinking as I was looking at the Microsoft
14 presentation how much of the really important information
15 about what matters to Microsoft and the investors in
16 Microsoft is in the information that was shown to us by Frank
17 earlier, and how much of it is in their financial statements,
18 as to how big a disconnect there is between the value of
19 their intangible assets and the intangible assets that are
20 recorded in their financial reports.

21 I think this is of critical importance. I think
22 the solution here may well be more in the area of this type
23 of reporting that you are going to be looking into then going
24 back to GAAP today and saying let's re-do GAAP and make all
25 of it economic substance.

1 MR. DIERMEIER: I would agree, particularly that in
2 my own firm, we would use the financials as reconciliation to
3 hypotheses.

4 CHAIRMAN POZEN: Ed?

5 MR. McCLAMMY: I agree totally with the overall
6 proposal. Just one specific comment on (b) on page 72. I
7 just question as I read that the practicality of getting that
8 done, of saying as of the date you issue or file the
9 financials, that you are saying at that date, you have all
10 the data current to address that.

11 CHAIRMAN POZEN: I think we put the word
12 "reasonably" in, "reasonably available," which is sort of a
13 catch all word.

14 MR. McCLAMMY: I don't think that gets there. I
15 think it still needs some more work. I think you could be
16 second guessed on well, in hindsight, there was some
17 information that you weren't aware of that came up later that
18 maybe you should have.

19 CHAIRMAN POZEN: We could change the word
20 "available," "accessible" or "provided."

21 MR. McCLAMMY: I think it just needs to give some
22 concept to materiality, like you would have in relation to --
23 when you file a financial statement, you don't go back and
24 look at everything.

25 CHAIRMAN POZEN: I think that we can easily add,

1 Greg, you tell me, "material facts reasonably available."

2 Let's put in "material."

3 I do think just to emphasize this discussion Mike
4 was having with Jeff, this is the view that I think underlies
5 quite a bit of the Committee's work, it is useful to improve
6 the financial statements but that in the larger context of
7 thinking about financial reporting, we have to be realistic
8 about what the financial statements can do and where they end
9 and where the analyst's job begins.

10 In terms of evaluation and forward looking, some of
11 this stuff is never going to be in the financial statements,
12 and I tend to agree with Mike, if we try to force it all into
13 the financial statements, we are losing some of the value of
14 the financial statements because there are things that the
15 financial statements can do well and there are other things,
16 whether we call them KPIs or not, which are important and are
17 going to be beyond that.

18 I think when we are talking about financial
19 reporting, we are talking about a combination of improving
20 the financial statements and also looking at these other
21 indicators, and that is an important conceptual basis for us.

22 I think if we can have a vote on Chapter 4, all
23 these proposals. Are there people on the phone, hooked in
24 members? Joe? Anyone?

25 (No response.)

1 CHAIRMAN POZEN: If there are, I'm going to say do
2 you dissent from any of the proposals that have been approved
3 so far?

4 MR. NUSBAUM: No.

5 CHAIRMAN POZEN: Okay. Therefore, we have their
6 approval. Is that okay, Jeff?

7 Can we have not just hands but voices saying how
8 many people approve, whether we are going to have approval
9 for these proposals in Chapter 4? Everyone who is approving
10 that, please raise your hand and say "aye."

11 (Chorus of "ayes" and show of hands.)

12 CHAIRMAN POZEN: I really think this has been an
13 excellent job.

14 MR. KROEKER: Bob, just for the record, on the
15 earlier votes, they were also unanimous except for the XBRL
16 vote where there was one dissent.

17 CHAIRMAN POZEN: Correct; thank you.

18 I think what we are now going to do is to take a
19 lunch break. We will come back promptly at 1:00. I believe
20 the Committee will be in Room 6000. This is not just lunch.
21 We want to go over some administrative details in Room 6000.

22 Anyone other than the Committee and official
23 observers should go to 6001 or 6002 where we have lunch.

24 Thank you.

25 (A luncheon recess was taken.)

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

2 CHAIRMAN POZEN: Can we get started again, please?

3 I think we are now going to move to Subcommittee 2,
4 standard setting. The chapter begins on 28. The first
5 proposal is on page 30.

6 David, you may want to take this in chunks, to do
7 each subsection. Whatever you want.

8 SUBCOMMITTEE 2 - STANDARD-SETTING PROCESS

9 MR. SIDWELL: I would like to thank -- we have
10 really had a number of meetings. We have benefitted from Bob
11 Herz, Con, John White, Mark and Russ, and a number of staff
12 people attending those meetings, which I think has really
13 helped us.

14 We also had in December here in Washington two days
15 of meetings. I think we found those very useful. As you
16 will see and as people have read this, we put a lot of
17 emphasis on the user investor and having more of a voice in
18 the process, a predominant voice.

19 I think it was very useful to get some of
20 those groups to help dispel some of the myths that we had
21 heard. I think we really benefited and I wanted to sort of
22 formally thank those people, while not here, who went to the
23 trouble of meeting with us.

24 I also, before getting into the specifics, would
25 just like to reiterate, and I think my Subcommittee is very

1 pleased, that we ended the discussion before the break on the
2 decision framework. That is very critical.

3 From our perspective and while there are a lot of
4 words in our report, a lot of the complexities in our view
5 will be solved by having more of an ability to accept
6 reasoned judgments and only deal with let's call it lack of
7 comparability at a point where observers in the system feel
8 like that level of comparability needs to be closed down.

9 I think that requires the type of work that Mike
10 and the Subcommittee did around professional judgment. It is
11 crucial in our view, if we are going to see the change in
12 behavior that is going to facilitate many of our
13 recommendations.

14 Before Bob gives me the hook, the first set of
15 recommendations using buckets is around increased user
16 investor involvement. I think you heard a little bit this
17 morning.

18 It is actually hard to sort of define exactly what
19 you mean. The way we have really thought about this is those
20 people really are making investment decisions. It isn't the
21 person who is an accounting expert who came from a job at the
22 SEC, at the FASB, and joined an investment firm, but we are
23 really talking about somebody who has the ability and is
24 involved in making investment decisions. That was for us a
25 very important aspect of this.

1 The whole aspect on 30 that is crucial here is that
2 this package of proposals is designed to underscore what we
3 think is important in terms of making the user perspective
4 the preeminent perspective in designing and administering the
5 standard system, the system around financial reporting.

6 Obviously, when the system was designed many years
7 ago, it was about having balance across a number of
8 perspectives and "balance" being the appropriate word.

9 We think it is important to say the primary area we
10 want to have attention given to is that the user investor
11 perspective should be in everyone's mind as they think about
12 standards.

13 I think actually it was interesting, the discussion
14 that we had at lunch, that reinforced just the need to say
15 why are we always doing this, and the user investor is why we
16 are here.

17 If you look at the developed proposal 3.1, which
18 has a number of ingredients to it, the first two are
19 basically saying that we think the system will be improved if
20 there is more representation on the foundation that has
21 oversight responsibility at the private standard setter, the
22 FASB, and also on the FASB itself, and on the staff of the
23 FASB, if there are more users engaged in those groups.

24 We think that it will bring a shift in balance as
25 items are discussed. We also think, and this is the third

1 bullet under 3.1 developed proposal, we think there is a
2 place in the time line where it would be very useful before a
3 standard is exposed for comments, so just before the exposure
4 draft stage, where users are engaged to say does this really
5 achieve what we want it to do. Does it improve current
6 practices? Is it something that is useful to investors in
7 making decisions?

8 Obviously, in no way do we want to imply that users
9 shouldn't be involved along the entire spectrum of the
10 process. Bob has done a huge amount to encourage that both
11 formally through setting up a number of different user groups
12 and also informally just by trying to build relationships
13 with users.

14 We think again if you are trying to design
15 statements that benefit users, it would be really useful to
16 have a formal step, and formal as opposed to the way it is
17 done today, which is probably less formal, is something that
18 would really benefit the process.

19 We have a number of other recommendations which I
20 will get to in a moment, which deal with having an agenda
21 advisory committee, but I think I will deal with that in a
22 moment.

23 The heart of 3.1 is very much about how do we get a
24 process which has more user involvement, shift that pendulum
25 a little bit from where it is today to one where the user

1 perspective is prominent.

2 CHAIRMAN POZEN: Do we have comment on 3.1?

3 MS. GRIGGS: I just have a question for you, David.
4 I have a perception that there are two kinds of users. Users
5 that have a short term frame of reference and users that have
6 a long term frame of reference.

7 I just wondered whether you gave any thought as to
8 whether there should be a balance. I have been told that one
9 of the reasons that the FASB has moved so much to value based
10 accounting is that people with a short term focus have said
11 they need to know values, whereas if you are a long term
12 investor, today's value is perhaps irrelevant because you are
13 more interested in the long term.

14 I am just wondering how you balance those.

15 MR. EVANS: I think that both short term investors
16 and long term investors are owners of the companies that we
17 serve, and therefore, entitled to the same types of
18 information.

19 I'm not sure I agree, Linda, that a short term
20 investor would be any more interested in valuation
21 information than a long term investor.

22 I think the most important thing is that we design
23 standards and design the financial statements that are
24 interpreting those standards from the perspective, the
25 preeminent perspective of the users themselves, and make sure

1 that we have ways to solicit user input and involvement so
2 that we always make sure we are enabling management to
3 communicate to the investors for whom the financial
4 statements are designed.

5 MR. SIDWELL: I think we also acknowledge that in a
6 way that it's rare that you get a view, that you will always
7 get different opinions expressed by different groups.

8 I think we also viewed it that we would expect to
9 hear that from different users, different investors, who come
10 from different perspectives.

11 I don't think we view this necessarily that it is
12 going to be as easy, that there is going to be this thing
13 that has a bow around it which is here's the total acceptance
14 of everything you are saying. I think that is too much to
15 expect.

16 CHAIRMAN POZEN: Greg?

17 MR. JONAS: As a user, I find the proposal 3.1
18 very attractive for very obvious reasons. I think no
19 endeavor, business or otherwise, will succeed, unless it puts
20 its customer first.

21 When we are talking about financial reporting, the
22 customer is obviously the user. It strikes me as entirely
23 logical that the user is first among equals of the
24 constituencies of the Board.

25 I certainly agree with what the Subcommittee has

1 said about the many things that under Bob Herz's leadership
2 the FASB has done to bring users into the process.

3 I had two additional ideas that are related to what
4 is said here, but they are enough different that it causes me
5 to just raise them for your consideration.

6 One is that today, when the Board considers in its
7 basis for conclusions explaining itself, particularly in
8 terms of benefits versus costs, there is a tendency to
9 justify benefits in terms of reconciliation to the Board's
10 conceptual framework.

11 That is certainly not a worthless thing to do.
12 That is a helpful thing to do. I think the Board can go one
13 step further, and I think it is entirely practical to do this
14 next step, and that is instead of asserting benefits to the
15 user, actually explain the benefits to the user.

16 I think it need not be just a big leap of faith.
17 You can actually sometimes empirically show that improvements
18 to financial reporting fit in in a certain way to an
19 investor's model and therefore, it is helpful.

20 To that end, with regard to field tests, one way to
21 do a field test is you gather a panel of users and you talk
22 about the new improvement that you are thinking about and
23 have the panel react.

24 Another way to do a field test is to actually ask
25 the user to apply their models and frameworks using the new

1 data if you can.

2 The ideal field test in my mind is the field tests
3 to see if it's practical, if they understand it, they can get
4 the numbers, and then it can be done at acceptable cost. The
5 user then takes those numbers and compares what they did with
6 what they got before and says yes, I can actually make a
7 better decision and here's why. That would strike me as
8 helpful, too.

9 MR. SIDWELL: Greg, if I may, actually, one of our
10 later proposals which we will talk about, has that very
11 thought that you are saying, that when we think about field
12 testing, field visits, and then the cost/benefit analysis, we
13 think that the benefits to the user part of that should be
14 formalized and be a key part of that cost/benefit analysis.

15 MR. EVANS: The other thing to your first
16 statement, don't assert the benefit, explain it, by having
17 the user panel in the fatal flaw stage, it would drive the
18 need to explain the benefit to the user. That would be a
19 fall out of the process.

20 Perhaps it would be even stronger to state it
21 explicitly. Thanks for that comment.

22 MR. BERESFORD: One of the things we did was to
23 sort of review the FASB's cost/benefit procedures by having
24 someone from the SEC Economic Analysis staff look, and I
25 don't mean to put words in their mouth, but at least what I

1 heard was the FASB was doing an excellent job but wasn't
2 communicating it as well as possible.

3 I think along the lines of what Greg has suggested,
4 they weren't giving themselves enough credit for the
5 specifics as to what had been done, particularly with respect
6 to the users.

7 MR. WALLISON: I have a question about the user
8 issue because I see users from a slightly different
9 perspective, and it also raises questions about the
10 complexity issue for me when I read the complexity section.
11 Maybe we will talk about that also.

12 It seems to me there are retail users, like me, a
13 person who just tries to find out about a company to make an
14 investment, and then there are the professional users. Those
15 who are the professional users may want more complex
16 financial statements.

17 What is our perspective here? We are trying to
18 make these financial statements more suitable for the retail
19 user but on the other hand, are we then taking away
20 information from the professional user that ultimately is of
21 great value to the retail user if the professional user
22 provides him with an analysis.

23 MR. EVANS: Thank you for that question. It is one
24 that we spent a lot of time on in our Subcommittee. I think
25 it is quite important.

1 The question really is who is the primary user that
2 we should be focusing the lens on when we develop the
3 standards, when we decide whether they are useful, et cetera?

4 Is it the professional analyst? Is it a retail
5 investor who is unfamiliar with financial statements?

6 We came out with something, we actually leveraged
7 off the work of one of the early drafts of your group, and I
8 think you referred to them as the "serious retail investor."

9 The way we have expressed the "serious retail
10 investor" is an experienced user investor who regularly uses
11 financial statements to make investment decisions.

12 We just had a perfect example of designing
13 something for that user, the Microsoft web site. That web
14 site is completely comprehensible to any serious investor.
15 Not only that, it's also usable for sophisticated investors,
16 who could benefit from an awful lot of the disclosure,
17 particularly in the links and the footnotes.

18 Even more than that, the whole process enables the
19 serious retail investor to get the benefit of some of the
20 sophisticated data that's in there by the way it was linked
21 in the Microsoft web site.

22 In my mind, Microsoft got it completely right.
23 That site was focused on the experienced user of financial
24 statements who is using it for investment decisions, and that
25 is who we recommend be the focal point of the user investor

1 that we are talking about here.

2 MR. WALLISON: If I can follow up, I was thinking
3 of it in a slightly different way. Using the complexity
4 issue as an example, one of the things that was discussed in
5 the complexity chapter was about the fact that we want to
6 avoid special kinds of rules for special industries.

7 It occurred to me at that time, and this will
8 illustrate, I think, what I am saying here, that the reason
9 you might have special rules for certain industries, is that
10 there are peculiarities about that industry, that the
11 specialist, the analyst, would really like to have
12 information about.

13 The same thing comes up here. I'm not saying how
14 is that information going to be delivered to the person, but
15 are we keeping in mind what I think are the most important
16 people involved in this process, and that is the people who
17 really go deeply into the financial statements and not just
18 what is in the financial statements themselves but who build
19 models and analyze them in that way.

20 MR. EVANS: I guess you and I would differ on who
21 we consider to be the most important people in the process.
22 I would consider the most important people in the process to
23 be the serious retail investor, the experienced user who does
24 not have the arsenal of analytical tools.

25 I don't think that even in the complex world that

1 we live in, professional investors are at a loss for getting
2 information. The victims of complexity are the serious
3 retail investors, the experienced user. That is the most
4 important person to focus on in the financial standard-
5 setting and financial reporting process.

6 MR. DIERMEIER: Bob, Peter, I don't think this is
7 much of a concern given all the things that we have here. I
8 wouldn't take any of -- the report -- the comments Mike made
9 before break in terms of the KPIs and the other types of
10 things -- really gets a lot deeper into that.

11 What came first, the oil industry and their way of
12 looking at reserves or the analysts? I think I know what
13 came first. It came out of Pittsburgh; right?

14 I think that just follows from that standpoint.

15 CHAIRMAN POZEN: Ed?

16 MR. McCLAMMY: I think any time you start focusing
17 more on customers, you have to immediately throw in there
18 more emphasis on the cost of providing that service. I think
19 for any business, and we need to look at this the same way,
20 yes, the customer comes first, but you have to balance that
21 with the cost of delivering what the customer wants.

22 I think if we are going to have this shift to the
23 customer focus, we ought to also add into the proposal
24 keeping an eye on the cost/benefit of providing that
25 information.

1 CHAIRMAN POZEN: I had one question, David, just in
2 terms of organization. The point on the fatal flaw review,
3 which seems to me a very good one, I guess I just wondered
4 whether or not that would be better handled in either 3.3 or
5 3.4. It seems to go more in the process of standard setting,
6 maybe with a cross reference here.

7 I was sort of looking for a chronology, which it
8 seems to me you have in 3.3, where you have the priorities
9 and the field tests, so something like that. Minor point.

10 MR. SIDWELL: Shall I move on?

11 CHAIRMAN POZEN: Yes.

12 MR. SIDWELL: If you go to page 34 --

13 MR. COOK: Just a real quick comment and ask a
14 question at the same time. I didn't know that we were going
15 to get to that fatal flaw review.

16 I might re-think that terminology. That doesn't
17 sound to me like giving people an opportunity to really take
18 a serious look at something and provide input. A fatal flaw
19 review, is there something in here so bad that this whole
20 thing is going to blow up. Maybe that terminology is
21 understandable to the group that it is addressed to.

22 MR. EVANS: I think you have a good point. The
23 idea was to have a panel giving comment and feedback before
24 it goes to public comments, so that the standard setters
25 could get --

1 MR. COOK: "Fatal flaw" is a very high threshold.

2 MR. SIDWELL: I think ideally what we were thinking
3 about, and you will see this a little bit later, and this is
4 a little bit tough when you are trying to organize the
5 material, which comes first, but I think we are trying to
6 encourage a process where as a standard is being developed,
7 that users as well as preparers and auditors are very
8 actively engaged along the process, so there is continuous
9 input on where the standard should go.

10 I think we are not trying to say that the only time
11 you involve a user is right at the end and they have this
12 sort of fatal flaw ability.

13 You hope any significant points emerge along the
14 way. I think what we were trying to address here and we
15 heard this from quite a few of the people we met in December,
16 that it is often when they see the package that views sort of
17 get finalized, get framed, so we felt it was very important
18 once a standard is sort of packaged and people can see it
19 from A to Z, you want to have it that the user says on
20 balance, this is --

21 MR. EVANS: Like a final stage review.

22 MR. SIDWELL: Yes.

23 MR. HERZ: I think your point is a good one. I
24 think what you are trying to do is build the quality in as
25 you are building it and not just having Inspector 12 at the

1 end of the line come back in and say, well, this doesn't
2 work, spend another two years, try again.

3 Our process is not designed to do that. Our
4 process is designed to touch base with lots and lots of
5 people as we go along.

6 MR. COOK: Question. Maybe this question really is
7 for Bob. I agree with the notion of more user investor
8 involvement/participation. I don't see any difficulty with
9 that at the FAF level, which is not a full time commitment.

10 A question is, I am too far removed from the
11 recruiting process, but will you get today candidates that
12 would enable you to fulfill this when you ask somebody to
13 make a full time commitment and make it for five years?

14 MR. HERZ: We shall see because we are right now in
15 the process of going out and trying to recruit exactly that
16 spot. I would say at this point we have not got a lot. A
17 lot of trees have been shaken. There are some people, some
18 names and all that.

19 It is not naturally because of the change in
20 compensation and all that, it may require people as a second
21 career almost.

22 MR. SIDWELL: When we met with people in December,
23 we asked them that question explicitly. I think it is really
24 no different than preparers trying to identify somebody.

25 I think we did hear through the various

1 organizations that exist that in their opinion they would be
2 able to identify some candidates who meet the characteristics
3 that Bob articulated.

4 CHAIRMAN POZEN: One thing I think you know, I
5 think Steven Cooper has gone on the Board part-time who is a
6 rather distinguished analyst in the U.K., and I think Mary
7 Barth is part-time. She has retained her professorship.

8 We may want to include this, to recruit users, some
9 flexibility. You might want to have some people, assuming
10 you can deal with the conflicts, somebody who was half time.
11 It's pretty hard to get a really top analyst to give up that
12 sort of comp.

13 I think that is something that they seem to be
14 successful with in the IASB.

15 Jeff?

16 MR. DIERMEIER: That is admittedly a challenge.
17 Bob, do you think if some of your new committees that you have
18 established in the last couple of years had been in place for
19 a while, that you wouldn't have some seed corn coming out of
20 those committees as well?

21 MR. COOK: Some of the people who are interested
22 now are exactly from that, and we did kind of view that a
23 little bit as a farm system.

24 MR. DIERMEIER: Bob, could you as a practical
25 matter make it work with full-time and part-time Board

1 members serving at the same time?

2 MR. HERZ: I don't think about it. Probably.
3 Particularly in a small group, it depends on the particular
4 people.

5 CHAIRMAN POZEN: It also would depend if they
6 were located between New York and Boston and you could
7 combine it with a professorship. It depends on what the
8 combination is and who the person is.

9 MR. COOK: The other thing that would be valuable
10 in this person is if they weren't completely out of the user
11 community for five years as opposed to being an active part
12 of it and being a part of the process. That would require a
13 different model than you have historically had.

14 I'd say think about it, whether you could suggest
15 at least consideration of that as an alternative. I would
16 think a lot of people might be able to do it half time who
17 wouldn't do it full-time.

18 CHAIRMAN POZEN: Shall we move on to 3.2?

19 MR. SIDWELL: 3.2 is again when we think about an
20 ideal system, governance is one of the areas that you
21 obviously have to think about.

22 We believed that the FAF is the right place for
23 that governance to reside over the FASB.

24 We have, as you can see at the top of page 34, a
25 number of recommendations. One, we did spend time as a group

1 going through the work that the FAF has done itself to review
2 the oversight structure and operations of itself, the FASB,
3 and GASB, and by the way, we are not putting GASB as part of
4 our scope.

5 We actually are very supportive of the
6 recommendations that they have made and we have laid out in
7 this report the principal ones.

8 Interesting enough, they don't address the question
9 of part-time Board members. One of the things that they do
10 suggest actually is reducing the number of Board members. We
11 again think that makes sense.

12 As you can see in our recommendation, one of the
13 things that obviously does, if you go from seven to five, the
14 one user that they have obviously has a bigger voice at the
15 table, and we did consider, although we don't recommend it,
16 whether actually more than one, and we have, as you can see,
17 the "at large" seats, as it were, we would ask them to
18 consider those Board seats being pointed at people who have a
19 particular user perspective.

20 We felt overall that the recommendations that FAF
21 has make a lot of sense.

22 We feel, and this is the second bullet, that one of
23 the things -- we have had a very active dialogue with Bob on
24 the question of the mission statement of the FASB -- we do
25 think it would benefit, and this is the second bullet here --

1 there was a lot of discussion about is there avoidable
2 complexity, some complexity may be by definition determined
3 by the nature of the transactions themselves, but would it be
4 useful to have one of the elements of the mission statement a
5 statement or an additional goal that one of the objectives of
6 the FASB should be to avoid complexity where it is not
7 needed.

8 Finally, in terms of governance, Bob has done a
9 huge amount in the last few years in a number of areas trying
10 to improve the processes.

11 One of the things as the FAF acknowledges its role
12 to have a greater handle on its oversight responsibilities
13 would be they implement some series of performance metrics to
14 determine whether those processes are effective.

15 I think we believe that given the nature of the
16 FASB, the multi-year nature of many of the projects, that it
17 would be very useful to have in place some performance
18 metrics.

19 That is really the heart of the enhancements we see
20 around governance, supporting the FAF proposals, adding an
21 enhancement to the mission statement around avoiding
22 complexity where it can be avoided, and third, that the FAF
23 in performing its oversight role, should put in place some
24 performance metrics that are put in place by the FASB that
25 they can review.

1 CHAIRMAN POZEN: Do we want to take comments on
2 this? Bob, do you want to comment on it?

3 MR. HERZ: I don't know whether actually in the
4 mission statement we would say serving the needs of users
5 while avoiding unavoidable complexity, but certainly agree
6 with the notion. We are not out there to create unnecessary
7 complexity. That is absolutely clear.

8 I think the thing about increased oversight and
9 relevant performance metrics is correct. I think it is
10 incumbent, in my own view, that the group performing the
11 oversight be appropriately representative of the user view.

12 That means the composition of the FAF, from where
13 it is now, will need to change.

14 MR. SIDWELL: Clearly, just to scale that for
15 everyone, and Jim and I were trying to work out precisely who
16 you tag in and in which way, but using the definition of
17 "user investor" that we have, where some are probably no more
18 than two of the kind FAF are meet that definition that we are
19 using. Clearly, that is a significant change from today.

20 MS. GRIGGS: I had a recommendation on the mission
21 statement. I was surprised that it didn't say anything about
22 the auditability of numbers that would have to be created by
23 standards. It didn't seem to be there.

24 I would think that would be something that should
25 be considered as well.

1 MR. HERZ: I think we would view the issues of
2 creating good standards mean that the relevant, reliable,
3 comparable, understandable, that the information produced is
4 there, and that the cost/benefit to the users, the
5 availability and cost to produce the information, the
6 auditability, all of those, are ingredients that go into that
7 overall quality.

8 I think the overall mission has to produce things
9 that are decision useful for the customer.

10 CHAIRMAN POZEN: My view of mission statements is
11 they are sort of cheap dates. We can add a few phrases here
12 and there.

13 MR. HERZ: Exactly.

14 CHAIRMAN POZEN: You can always add a few phrases.
15 I had another question just for clarification. On these
16 performance metrics of the FAF, I just think we need to
17 understand and just make clearer how that differs, for
18 instance, from the post-effective reviews.

19 MR. SIDWELL: Bob, just to explain it. These are
20 metrics that will be put in place by the FASB that are
21 monitored by the FAF. It would not be just on one part of
22 the FASB process. It would be on all those parts of the FASB
23 process, between the FAF and FASB, I consider critical to the
24 successful execution of the FASB mission, which is no
25 different than I think Chris and his team were describing

1 this morning when they talked about critical performance
2 indicators for Microsoft.

3 What are the KPIs for the FASB that are then
4 monitored by the FAF. Timeliness might be one of them.
5 Avoiding undue complexity may be another.

6 CHAIRMAN POZEN: So that they did the post-
7 effective reviews as opposed to --

8 MR. SIDWELL: Yes.

9 CHAIRMAN POZEN: I know that FAF seems to in their
10 proposals contemplate a sort of half time FAF chairman. You
11 clearly are going to have more of a role in that.

12 The other thing and maybe Jim or somebody else can
13 advise, they have a comment process for these FAF proposals
14 that I think ends pretty soon, if I remember. They are
15 intending, if I remember, to try to adopt their proposals on
16 February 26th or something like that.

17 MR. HERZ: The comment period ends February 10th.

18 CHAIRMAN POZEN: Just a question of how -- we have
19 met with them. I don't think on the one hand it is within
20 this Committee's mandate to formally submit a comment letter,
21 but we want to share with them what we are doing.

22 MR. SIDWELL: This report, and that is why we were
23 reasonably explicit in the report about a number of our
24 recommendations and our views on them, so that the
25 information that we have considered is available for their

1 benefit.

2 CHAIRMAN POZEN: We can just make sure that
3 somebody sends it over to Bob Denham's group. Great.

4 Anything more on 3.2?

5 MR. DIERMEIER: Bob, given the timing of the
6 comments and the fact that it says "by formally supporting
7 the proposals," which means, I think, all of the proposals,
8 I'd actually think it would be better if the proposal just
9 recommended some of the principles we are talking about here
10 as opposed to seven people, 4-1 versus 3-2 and all those
11 types of things.

12 The investment professionals I represent, when they
13 see "at large," they know that historically that meant a non-
14 user, so they immediately interpret that way. They would at
15 least want to see two users represented out of the five.

16 There are questions about what the words "active
17 oversight" means. "Active oversight," from a trustee, that
18 is a strange combination of two words, isn't it? You want
19 oversight. I think that language almost has some history to
20 it in terms of what you would like to see from the FAF as
21 opposed to what some of you in your typical Board roles might
22 view as kind of appropriate oversight.

23 CHAIRMAN POZEN: I think, Jeff, we are not going to
24 have much impact if we just say something very broad and
25 vague. I think most of these things in terms of the size and

1 the chairman's role and the majority voting are to have a
2 more expeditious process.

3 I think if you feel that we should say more
4 specifically to user representatives, then that is something
5 we ought to discuss here.

6 I think if I understand David's proposal, it is to
7 have one definite and then sort of encouraging them to have
8 a user as the at large. We could take a step further.

9 I think if we want to have impact, we have to say
10 something specific.

11 MR. SIDWELL: I think if you go back, and Jeff, I
12 think maybe this would help you, if you go back to page 31,
13 we actually talk explicitly about composition. We
14 actually are recommending, as I alluded to earlier, that it
15 is a preparer and auditor and at least one user investor, which
16 as we said, with a Board of five, increases the users, but then
17 if you look at point two, in the last paragraph, the remaining
18 at large Board members should be selected based upon the most
19 qualified individuals with a breadth of experience to ensure
20 that the perspective of user investors are represented.

21 We felt it was important and we spent a lot of time
22 in the Committee debating this. We didn't want to just say
23 add one more user. We felt it was important to say they
24 should go to the best talent who can bring that perspective
25 to the table.

1 MR. DIERMEIER: I think we should.

2 CHAIRMAN POZEN: I think Jeff is raising an issue,
3 he would like to say that. I think people should discuss it.
4 We will see what the Committee's view on that is, to have two
5 out of the five be users.

6 I personally believe that you handled it in a
7 pretty diplomatic way, suggesting that qualifications should
8 be heavily weighted toward user input.

9 Scott?

10 MR. EVANS: The other thing to keep in mind here is
11 we are behind the notion of getting away from constituency
12 based positions. We want to ensure that the user, and we
13 have had trouble getting sufficient user representation on
14 this particular body, we want to make sure there is at least
15 equal representation of any sort of constituent based
16 nominees.

17 The idea of truly at large appointments should be
18 done, and given the preeminence of the user perspective in
19 the process, we feel that for users, it ought to result in at
20 least one. It's a little nuance, but we were concerned, at
21 least I was concerned, that if you came down too hard and
22 said there have to be two users, that you are impeding the
23 direction of the process getting more towards at large, best
24 candidate for the job representation.

25 MR. DIERMEIER: I think Bob would agree, it's more

1 than a little nuance. It is really fundamentally changing
2 the notion of at large.

3 CHAIRMAN POZEN: I think we can just take a vote on
4 it. How many people want to go and --

5 MR. HERZ: Are you talking about the FASB Board or
6 the FAF?

7 CHAIRMAN POZEN: FASB. I think he is saying when
8 you reduce it to five, then two of those five should be
9 investor representatives. The way we have it now is one of
10 those, at least one of those five should be an investor, and
11 in looking at the two at large, investor expertise should be
12 considered thoroughly.

13 MR. SIDWELL: Should be predominant.

14 MR. BERESFORD: Bob, I think there is one more
15 important thing before you call for a vote.

16 CHAIRMAN POZEN: Sure.

17 MR. BERESFORD: The proposal from the FAF is to
18 actually have four assigned seats, a preparer, an auditor, a
19 user and an academic. We don't say it quite explicitly in our
20 report, but basically we are saying we don't think there
21 should be an assigned seat for an academic. There should
22 just be three, and then the other two should be the best
23 available people with hopefully user perspective.

24 CHAIRMAN POZEN: I think that is an important
25 point. Thanks for adding that.

1 MR. COOK: This can't sound like much of a
2 contribution, but I have a concern that you are going to find
3 one user on a full-time five year commitment that you want
4 for this, now you are thinking about having two, and I would
5 just say it doubles the complexity of that, unless you have
6 candidates lined up.

7 CHAIRMAN POZEN: How many people want to go Jeff's
8 way here, please raise your hand?

9 (Show of one hand.)

10 CHAIRMAN POZEN: I think we are going to stick with
11 what's in there.

12 MR. DIERMEIER: Are you with me, Peter?

13 MR. WALLISON: Yes.

14 (Laughter.)

15 CHAIRMAN POZEN: The people on the phone, I'm sure,
16 were supportive.

17 MR. COOK: Jeff, do you have people lined up to do
18 this? Not meaning committed.

19 CHAIRMAN POZEN: He just has to work out their
20 bonus structure.

21 MR. COOK: Do you have people who are going to do
22 this on the time commitment that's required?

23 MR. DIERMEIER: As we said earlier, ITEC and some
24 of those other committees that had been in place earlier, and
25 I think our organization could have done a better job of

1 trying to source people and bring them through some of our
2 committee structures, but as I've been traveling around, I
3 have found some organizations that I think will provide --
4 some major organizations -- I just never ever thought of the
5 notion that they could succumb somebody to this kind of an
6 effort.

7 I'm just wondering have we thought about other
8 things we might suggest that makes this more feasible, like
9 not having to commit to a five year term.

10 CHAIRMAN POZEN: I think we should put in language
11 saying "half time," "not full term." I think that FASB would
12 feel that someone that doesn't have a pretty long term
13 commitment doesn't sort of get into the flow and have to re-
14 train them.

15 If somebody really insists on a four year rather
16 than five year, I'm not sure it would be that big a deal.

17 MR. HERZ: The only comment I wanted to make is
18 that even if you look at our current Board, people are not
19 monolithic in their backgrounds and experience. A lot of
20 people have multiple experiences in their career.

21 I think that is an important ingredient that goes
22 into the trustees' considerations as well. If you get
23 somebody who has actually been in substantive ways on various
24 sides of the reporting process, maybe they are even better.

25 CHAIRMAN POZEN: Let's move along to 3.3 on page

1 36. David?

2 MR. SIDWELL: 3.3 is very much directed at the
3 actual process that the FASB follows. You can see that
4 under 3.3, there are two bullets.

5 We spent a lot of time on both of these, both in
6 the meetings we have had with Bob and his team, as you heard
7 from Denny earlier, we got some help from the SEC on parts of
8 this. We asked this explicitly when we met in December.

9 The first of the elements is that in the world
10 where Bob as chair has a lot of ability to influence the
11 agenda, which is one of the recommendations under the FAF,
12 that he has control of the agenda.

13 We think there are real benefits to having an
14 advisory group that is focused on the agenda. We are not
15 talking about changing the role.

16 What we are envisioning here, if you think about an
17 environment where as standards move to be more objectives
18 based, as we are trying to deal with the question that we
19 discussed before lunch, that you may see a lack of
20 comparability, and you want to begin to say how do we
21 deal with that lack of comparability, and some of that will
22 be observed first of all by the SEC, whether it is Corp Fin
23 or OCA.

24 We think there is real value to having a group that
25 meets on a very frequent basis, that formalizes much of the

1 informal dialogue that comes today between the SEC and FASB,
2 the audit firms and FASB, and this advisory group would
3 really help Bob frame what are the issues that we need to
4 address.

5 We are envisioning, and this is the recommendation
6 that follows later on 3.4, that we think the FASB should be
7 the source of U.S. GAAP, and that if we are going to reduce
8 the number of people who are issuing guidance that may be
9 interpretative but always seems to take on the
10 characteristics of U.S. GAAP, we think it is very important
11 that Bob has a lot of input on what are the priorities, where
12 are the areas that we should be focused on, so that the need
13 for different people to issue guidance is reduced, and that
14 there is a clear understanding of who will provide guidance,
15 what is its status, is it authoritative or not.

16 It really allows on a real time basis a discussion
17 of what are the current issues that need to be tackled.

18 It is something we spent a huge amount of time on,
19 as I said. We think it would really enhance the process by
20 having a very real time feedback loop of the people who are
21 seeing the results of the standards in practice, feeding that
22 back very quickly to Bob, so that priorities can be
23 established, making it very clear about who is going to
24 tackle the issue.

25 That is the essence of the first part of 3.3. The

1 second part is we think the process would be enhanced by
2 improving the whole field testing, field visit, cost/benefit
3 analysis. This is obviously an area that it is hard to say
4 this is the gold standard.

5 Observers say it is very difficult to always do,
6 for instance, cost/benefit analysis, but we think if you take
7 the various pieces, field testing, field visits, to the
8 extent that the FASB can, as it begins a project, identify
9 users, preparers, auditors, others, to engage from day one,
10 that they will really benefit from real time information
11 about the issues that they are considering.

12 Importantly, we feel that before a standard is
13 issued, a detailed cost/benefit analysis should be performed,
14 and the FASB does a lot of cost/benefit analyses today. We
15 think a lot of this is actually about just instead of having
16 a very abbreviated statement of the costs/benefits, to lay
17 out the items that have been presented.

18 We heard again this morning that there are real
19 benefits to lay out what is the impact of the users
20 explicitly in the proposed standard.

21 I think we feel there are some areas where that
22 process can be improved. Importantly, again, one of the
23 recommendations that comes later is around post-
24 implementation reviews. We think that gives you another
25 opportunity after a standard has been issued and people are

1 actually dealing with it in practice to circle back and
2 validate the cost/benefit assertion that was made before a
3 standard was presented.

4 Obviously, a lot of this is taking processes which
5 are somewhat in place today and trying to improve them and
6 formalize them. We are not in any way trying to assert that
7 much isn't already being done.

8 3.3 is around trying to improve the process at the
9 high level by having Bob as chair have the benefits of an
10 advisory group to help with priorities, help with identifying
11 issues, formalizing in many ways some of the dialogue that
12 goes on in practice today.

13 CHAIRMAN POZEN: Okay. Do we have comments on
14 either of these proposals? Does anyone have any concerns?

15 Greg?

16 MR. JONAS: Just one brief one. First, I find 3.3
17 to be a very compelling set of ideas and compliment you on
18 that.

19 It's obviously tightly linked to the FAF
20 recommendations that the agenda be under the control of the
21 FASB chair. I find that supportive as well, to the extent of
22 getting stuff on the agenda, but I'm concerned, not because
23 of Bob, you know --

24 CHAIRMAN POZEN: Honest Bob.

25 MR. JONAS: Honest Bob would never do what I'm

1 about to describe. We don't want control over the agenda to
2 be ineffective, a right by the chairman to veto accounting
3 standard changes he might not like.

4 I could envision Bob's successor, not nearly as
5 honest, who adds a project to the agenda. The project
6 doesn't go the way that chairman feels it should, and then
7 the chairman takes the project off the agenda.

8 I am wondering why wouldn't we have the chairman
9 control the agenda additions but have the Board control agenda
10 deletions?

11 MR. DIERMEIER: I would like to second that. There
12 are quite a few people that would feel the same way.

13 CHAIRMAN POZEN: I'll take responsibility for why
14 "delete" is in there. I think it was in there when we
15 debated back and forth. I guess the sense was if you really
16 wanted to get a streamlined process and you really wanted to
17 get these priorities, we have projects that have been
18 cluttering up the agenda there for years, literally, five
19 years, ten years, 20 years.

20 It seems like so far, you know, we can't get a
21 majority vote to get them off. I think that was the thought.

22 I don't think it is a go to the mat issue. People
23 ought to talk about it.

24 MR. HERZ: I certainly wouldn't object to that. I
25 think it's built into the FAF oversight. I think if a

1 chairman were to do that, the rest of the Board members, ones
2 concerned, would immediately in an active oversight mode do
3 an ethic complaint to the FAF, and there would be some kind
4 of process that would go on.

5 I think it is in part of this thing, given that
6 every Board member has a vote on every standard and technical
7 issues within the standard, it's very difficult for the
8 chairman, other than in a collegial way, to do things
9 like that, I think.

10 CHAIRMAN POZEN: This is on page 35. There is one
11 bullet here. If people feel strongly, we can delete it.
12 That was a bullet that specifically says the chairman should
13 have the right to delete. I don't think it's a huge deal one
14 way or the other.

15 MR. HERZ: On some of these recommendations, just
16 to point out, I think we mentioned that up front, and today,
17 Bob, you did a very good job, but some of them, how they
18 would get operationalized are very path dependent on the
19 international considerations.

20 CHAIRMAN POZEN: Absolutely. I think we can take
21 that bullet out.

22 MR. COOK: Just a quick question. Did you have any
23 thought about suggesting the termination of FASAC? I am just
24 wondering how many advisory groups any one person needs. You
25 have FASAC. You have the agenda. You have FAF.

1 MR. SIDWELL: We heard in December that FASAC
2 actually provided, and Bob himself feels it plays, a very
3 important role as you think about the longer term projects
4 that should be framed.

5 I think what we were trying to do here is have
6 something very timely, something that encourages real
7 dialogue with those people who really understand what the
8 current issues are.

9 MR. HERZ: I think that the recommendation here, if
10 you think about it, we have an EITF agenda committee now that
11 deals with those kinds of issues, and then we regularly talk
12 with the SEC staff and the PCAOB.

13 It is really kind of bringing all that together in
14 a more formalized way, I think more, in my own view, on these
15 kinds of things that are bothering the system, and maybe
16 avoiding the need for standard setting in a lot of cases and
17 saying, you know, there are other ways to do things other
18 than creating another piece of paper with a rule.

19 CHAIRMAN POZEN: Any other discussion on 3.3?

20 MR. DIERMEIER: Bob, a question. The reduction
21 from seven to five, would you reduce some of the
22 responsibilities in terms of travel and speaking engagements
23 and things like that if you are going from seven to five?

24 You are losing a fair amount of that capacity.

25 MR. HERZ: Correct. Just to give you an idea, I

1 think last year, I counted that Board members did
2 collectively 200 speaking engagements. Yes, we would
3 proportionately have to reduce some of that and some of the
4 direct engagement that we have with some folks.

5 There are always tradeoffs.

6 MR. DIERMEIER: For some of us, is nine better than
7 seven versus five, with that hanging over it, it almost seems
8 like seven would be putting a real capacity challenge to
9 yourself. You would know better.

10 MR. HERZ: I think what our thoughts were that we
11 were modeling ourselves after the excellent model of the SEC
12 and the PCAOB.

13 (Laughter.)

14 CHAIRMAN POZEN: Which came first?

15 MR. HERZ: And FASB.

16 MR. SIDWELL: One of the things we are going to
17 come back to is actually trying to provide some advice on
18 what the priorities should be. Obviously, for that, and
19 there is a conceptual proposal laid out here, we want to
20 consider the impact of international.

21 If you think about the capacity of the Board and
22 the staff, it is a relatively small group of people. Some of
23 the issues today is there are projects which there is no way
24 they can get done given the number of things that are on the
25 agenda.

1 CHAIRMAN POZEN: I think that brings us to 3.A on
2 page 40. Since this is a conceptual approach rather than --

3 MR. SIDWELL: I just addressed that one.

4 CHAIRMAN POZEN: I don't think we have to go over
5 it, but if somebody has any comments on that, if somebody
6 wants to make a comment, it is in a pretty preliminary phase.

7 If there are not any comments, let's move on to 42,
8 where I think we are getting into some meat of some of the
9 practical things here.

10 Do you want to lead off on 42, David?

11 MR. SIDWELL: Yes. One of the things we talked
12 about with you all in November was this whole question of who
13 gives interpretive guidance, and the fact that one of the
14 big drivers of complexity has been the number of people who
15 give some type of interpretive guidance and while it may
16 not formally be intended to be adopted as GAAP, becomes
17 adopted as GAAP.

18 The essence of 3.4 is to encourage that the FASB
19 and obviously to the extent, the IASB, for foreign
20 registrants, in setting standards that can be followed, but
21 let's just use the application of the FASB to make this
22 simpler, that the FASB is the sole standard setter in terms
23 of authoritative accounting standards.

24 When you look at what we are saying here,
25 obviously, one of the key things in doing this is where is

1 the line between authoritative and not authoritative, and the
2 FASB has spent a lot of time working on the codification
3 project. That project is very near completion. We are very
4 supportive of it.

5 We really think it enables to set a standard of
6 what is authoritative in the minds of the FASB. We think
7 that effort should be continued with the work that the SEC is
8 also doing in terms of thinking about and integrating to the
9 extent possible its guidance, so that there is in many ways
10 one formal source of authoritative guidance, both FASB and
11 SEC.

12 We then think once that codification is in place,
13 and this is the third bullet, that using the FASB as the
14 example as opposed to trying to address IFRS, the FASB
15 should be the issuer of authoritative guidance.

16 We do acknowledge there may be some circumstances
17 on a particular issue where the SEC through OCA as one
18 example may wish to issue guidance, some level of
19 interpretive guidance.

20 We would encourage both the FASB and SEC to the
21 extent that they do that to be judicious in providing
22 interpretive guidance.

23 We have very much in mind that we would like to see
24 a very interactive process between when a standard is issued
25 that the FASB and SEC consider what is happening in practice

1 once that standard is issued, and then be very proactive in
2 considering are they seeing some things that would require
3 that standard itself to be changed, and as part of that
4 process, be very judicious about providing interpretive
5 guidance.

6 Otherwise, I think we feel we will just get into
7 the cycle that we have been in, that there is a lot of
8 interpretation that is provided.

9 What is important here, and this is the last bullet
10 here, is that any guidance that comes from other sources is
11 truly non-authoritative, and that the system accepts, and
12 this is one of the key behavioral changes that we have been
13 talking about today, the system accepts that if any group,
14 one of the firms, puts out something to help implement a
15 standard, that it is not necessarily any better than a reasoned
16 documented rationale for an alternative treatment.

17 We think that is a very important change in
18 practice that is going to be key, otherwise, I think we feel
19 we are going to be in this same loop, what is considered non-
20 authoritative becomes accepted as authoritative.

21 The final point, I'm slightly out of order,
22 obviously, we do strongly believe that any implementation
23 guidance that comes out of the SEC or FASB should have
24 complete due process around it, which is the last bullet.

25 This is for us a very important --

1 CHAIRMAN POZEN: It's related to what is on pages
2 44 and 45. You are recognizing that the SEC has registrant
3 specific guidance.

4 MR. SIDWELL: Yes.

5 CHAIRMAN POZEN: I guess I just had a question and
6 maybe Con and John, the notion here is very strongly that
7 interpretive guidance, implementation guidance, should come
8 from FASB.

9 There is a recognition that at least in certain
10 circumstances there might be non-registrant specific guidance
11 coming from the SEC on larger issues on which there would
12 have to be due process.

13 I wasn't quite clear in what instances that would
14 be justified.

15 MR. SIDWELL: The reason, and this is on page 44,
16 that it's all conceptual, is we have spent a lot of time with
17 John and his team, Con and his team, talking about this point
18 of how registrant specific matters stay registrant
19 specific.

20 At what point does it matter that you see what with
21 one registrant becomes broadly applicable, and if, for
22 instance, Corp Fin or OCA see a matter that they think is
23 more broadly applicable, what is the process by which that
24 gets disseminated?

25 What we would like to see, and we spent a lot of

1 time talking about this point, is we would like to see that
2 there is a feedback loop, that if after the implementation of
3 a new standard, Corp Fin is seeing some practices that they
4 don't like which, for instance, may have been producing too
5 great a lack of comparability, that they would like to see
6 reduced, we would like there to be an active dialogue with
7 Bob and his team and decide who is the right person, which is
8 the right group rather, to issue guidance to increase that
9 level of comparability.

10 CHAIRMAN POZEN: If I understand this correctly,
11 and if I'm wrong, please tell me, if this works the way you
12 want it to, then the OCA would never be issuing a general
13 interpretation. It would always be out of FASB or there
14 would be registrant specific stuff coming out of Corp Fin.

15 Is that correct?

16 MR. SIDWELL: I think ideally. Again, through this
17 agenda process, advisory process, to the extent there is
18 agreement between Bob, Con, John, why doesn't the SEC issue
19 this guidance or the SEC has a strong view that they want to
20 issue that guidance, I think we are saying that is okay, we
21 just think you should have significant due process in the way
22 that if the FASB had done it, they would have to follow.

23 MR. KROEKER: Bob, an example of this, Conrad
24 issued a letter on Statement 140 and the streamlined loan
25 modification procedures that the American Securitization

1 Forum has talked about.

2 One could say that provides accounting clarity.
3 There were a lot of questions in practice about that. It
4 doesn't just affect one or two registrants. It provides some
5 temporary guidance.

6 Actually, in the letter, it says this is an interim
7 step, an interim piece of guidance, if you will, but the hope
8 is that the FASB will clarify, if necessary, the application
9 of 140. I don't know if that is inconsistent.

10 CHAIRMAN POZEN: I don't think this is a major
11 deal, but on the top of page 44, it's a little too shorthand,
12 "may be judicious when determining when to issue
13 interpretative."

14 I think you ought to say it more clearly, that they
15 can decide in an appropriate case for the SEC to do it,
16 because it was a little shorthand.

17 MR. SIDWELL: That is the intent. I would remind
18 people these are conceptual. We want to work these through
19 with the SEC.

20 CHAIRMAN POZEN: We will just freshen up the
21 language.

22 MR. HEWITT: I think that is an excellent point. I
23 issued a similar letter two or three days ago on FAS 140,
24 very narrow application or lack of anything in the standards
25 pertaining to modification of mortgages in the subprime market.

1 I issued a similar letter on the backdating of
2 stock options last September of 2006. We had many, many
3 registrants that had accounting questions. It had nothing to
4 do with the legal side of the back dating.

5 We came up with seven different scenarios and
6 published that letter so we would one, give accounting
7 assistance more than interpretation of anything, to how do
8 you account for this thing with the different scenarios.

9 We have to do it fairly fast and fairly broad.
10 Otherwise, we will end up with a lot of restatements and
11 everything else if we don't.

12 CHAIRMAN POZEN: I think, if I understand it, is
13 only being requested here is that this be worked through the
14 agenda setting committee, so there would be just a decision,
15 okay, this one is for the SEC.

16 MR. HERZ: Formalization. We would have to go
17 through due process, that would take time, in this scenario.
18 Quite frankly, we didn't want to add a bag of temporary rules
19 to the standard, when the standard was already being
20 reconsidered.

21 CHAIRMAN POZEN: It might be good also on top of
22 page 44 to give as an example the temporary rules. That
23 might be useful to add to that.

24 Are there other comments on these pages here? Ed?

25 MR. McCLAMMY: To that last point, I think the key

1 is to make it clear what's authoritative and what's not
2 authoritative. If what Con put out is authoritative and
3 everyone knows that, I think that process sounds fine.

4 CHAIRMAN POZEN: I assume when the decision is made
5 that FASB says we are going to let SEC do it, it is
6 authoritative.

7 MR. McCLAMMY: Right.

8 MS. GRIGGS: May I just make a point? I think
9 your conceptual approach 3.B might be inconsistent with ASR's
10 4 and 150. As you think it through and talk to the staff, I
11 think ASR's 4 and 150 say very clearly that a registrant can
12 look at what other companies have done and rely on that for
13 explaining a particular accounting standard, unless the
14 Commission has spoken otherwise, that is an acceptable
15 methodology.

16 Those are sort of registrant specific items. Under
17 ASR 4 and 150, that is almost authoritative.

18 MR. SIDWELL: I think what we were trying to do,
19 Linda, was make sure that there is room, that might not be
20 the only answer.

21 What we were trying to do in this recommendation,
22 in this conceptual recommendation, was if a particular
23 registrant matter, which obviously is very much dependent on
24 the facts and circumstances for that registrant, before it
25 becomes okay, the SEC has provided this guidance to this one

1 registrant, before that becomes now everyone else has to do
2 it the same way, that this capacity, basically if the SEC
3 wants to generalize it to everyone, there's a process to do
4 that, or if it is only registrant specific, it need not be
5 applied by everyone else, whereas I think today, the concern
6 is that those instances become -- they take on a larger life
7 than you would want them to.

8 It goes again with this judgment framework that we
9 were talking about earlier. If it isn't clear and if it
10 isn't absolutely only one way, we think that a reasoned
11 judgment, obviously, if it is an objectives based standard,
12 may produce a different answer.

13 We don't want to have it that alternative answer is
14 precluded, which I think some people today feel it is.

15 MS. GRIGGS: I think you might just want to look at
16 the words. I think the way it is written may not be
17 completely clear.

18 CHAIRMAN POZEN: I think Linda makes a good point
19 that we should take into account there.

20 I think we want, in the interest of time, to move
21 on to page 48.

22 MR. SIDWELL: This again is part of this. If
23 you're thinking along the lines of much more objectives based
24 standards, by definition, that means you are going to see
25 more diversity in the way those objectives get applied.

1 We really have two very linked proposals here, the
2 first of which is saying that there should be a period during
3 which while a standard is effective, that it is viewed as a
4 transition period, where there is going to be a lot of
5 learning about how that standard should be applied, a lot of
6 learning about what is acceptable diversity and what isn't
7 acceptable diversity.

8 We think the system would benefit from having more
9 flexibility during that period, so you don't get into the
10 situation where because the number of alternatives are
11 reduced, that you are in the situation of unnecessary
12 restatement, as you learn more about it.

13 Secondly, obviously to the extent that you are
14 learning more during the initial implementation of a new
15 standard, we think it is very important that the FASB has a
16 very formal post-adoption effectiveness review, so they can
17 really actively consider, look at the results that the SEC is
18 seeing, have discussions with the auditors about
19 auditability, the preparers and the users about did the
20 standard have the benefits it was anticipated to have, did it
21 have on the other hand unanticipated consequences, and take
22 the appropriate steps based on that formal post-
23 implementation review.

24 This is very much designed to try and reflect the
25 fact that in an objectives oriented world, there is going to

1 be some level of diversity, that might be okay, and you need
2 to deal with how, if you see too much diversity, you want to
3 close that diversity down.

4 CHAIRMAN POZEN: Greg?

5 MR. JONAS: This strikes me as entirely reasonable.
6 My only point relates to transition. It is a point that I
7 didn't see here, and I wondered if you considered it and if
8 not, maybe you might want to.

9 Lengthy transition periods. By "transition," I
10 mean companies that are adopting a new accounting standard,
11 lengthy transition periods in my experience are the enemy of
12 comparable reporting.

13 I would be a fan of point in time transition. If
14 we figure that companies need two years to get ready for a
15 new accounting standard, we pass the accounting standard
16 today, we set the date two years from now, but nobody goes
17 for two years, and then everybody goes on the same day.

18 I find that more appealing than saying the goal
19 line is two years, get there whenever you feel like it.

20 MR. SIDWELL: We need to clarify the words. That
21 is not what we were intending. We were anticipating there
22 would be one date, but there would be some period after that
23 date when you learn a lot about the issues that have occurred
24 as people try to implement that standard.

25 CHAIRMAN POZEN: I think there is a point that

1 maybe I didn't get either. Is it possible -- part of the
2 notion here was that we were going to learn something during
3 this transition period by having some empirical experience.

4 If you took Greg's point of view, no one would be
5 allowed essentially to use the new standard for two years,
6 that is different than what we were suggesting.

7 It's not just the question of having an end point,
8 which we would have, but I guess this is what we are
9 struggling with, how do you do good cost/benefit analysis?

10 You can try to predict in advance as much as you
11 want what's going to happen, but until you have a little
12 empirical experience, you are kidding yourself, because you
13 don't really know what it is.

14 MR. BERESFORD: The FASB has moved most recently to
15 have everybody adopt at the same time. We didn't really
16 comment on that in the report. We were simply saying that
17 once everybody implements, then that's when people start
18 getting serious with the issues.

19 For some period of time after that, we feel there
20 should be an expectation that not everybody is going to be
21 doing all the details in exactly the same way.

22 MR. JONAS: I'm in violent agreement with that,
23 with the point that once we got transition, there is a
24 learning period that follows.

25 My point is the single point of transition, the

1 point that Bob and I may disagree about, is exactly the point
2 that I didn't see in our thinking but that I would advocate
3 be in our thinking.

4 CHAIRMAN POZEN: I may be a little confused. FASB
5 adopts a standard and says a year and a half from now, it
6 becomes effective. Then do we contemplate that the
7 transition period starts from that effective date and runs
8 for a year or two while we work out some interpretive
9 issues?

10 Is that what we want to be recommending?

11 MR. JONAS: Prior to the so-called transition date,
12 nobody goes.

13 CHAIRMAN POZEN: Prior to the effective date, no
14 one goes.

15 MR. SIDWELL: You are suggesting that we do away
16 with early adoption?

17 MR. JONAS: Correct.

18 MR. EVANS: You are just trying to ensure that
19 everybody has the same year and a half of time?

20 MR. SIDWELL: Yes. We will clarify that.

21 MS. GRIGGS: Can I just ask one question?

22 CHAIRMAN POZEN: Yes.

23 MS. GRIGGS: How do you know about this diversity
24 if there isn't disclosure? Don't you almost need to have
25 some kind of a disclosure mechanism so that people know there

1 is the diversity?

2 MR. SIDWELL: I think, Linda, that is another great
3 question. I think we were envisioning this agenda advisory
4 committee as one source, that what John's team, what Con's
5 team is seeing, the type of questions they are getting, what
6 the auditors see, what questions are coming from users, what
7 questions preparers are raising, that will really help
8 identify some of the issues, plus the benefits of having this
9 post-implementation review, will be two very key sources of
10 understanding where too much diversity is occurring.

11 MS. GRIGGS: Might users benefit from some
12 disclosure?

13 MR. GOLDEN: Linda, I think this goes in with the
14 professional judgment framework earlier, and at the time the
15 standard is adopted, not all questions will be answered and
16 some will have to express professional judgment.

17 Embedded in there, if there are two reasonable
18 accounting policies, there is a requirement to disclose that.

19 What I think one of the recommendations is is that
20 the standard setter stands down for maybe one year or two
21 years and doesn't race to answer every question.

22 I would expect the standard setter to look at some
23 of those disclosures to see if there is diversity, but there
24 is a requirement today if there is alternative accounting
25 policies to disclose that.

1 MR. SIDWELL: It's interesting actually said
2 another way. For instance, one of the standards, and it is
3 written up in one of the other committees, about the fair
4 value option. This is permitted by the FASB rule if after
5 some period of discussion and review of the issues that's
6 raising, that the FASB wants to re-propose that accounting, I
7 think that is what we are envisioning.

8 We would like to see it happen sooner than waiting
9 for some period of time before if necessary changes are made
10 to a standard.

11 MR. HOLM: I would like to add, I agree it should
12 be done soon and quickly. I think this is trying to find an
13 appropriate balance, reasonable diversity at the same time
14 folks like us, such as regulators and certainly some
15 analysts, comparability of information is very important to
16 us as regulators. We do a lot of data analysis and
17 consistency is important.

18 That being said, I think the important thing is
19 that this post-effective review actually gets done, that it
20 be done relatively quickly.

21 I'm a little concerned. I heard earlier that FASB
22 has so many projects already, just for the staff to do what
23 they already have to do is challenging. I think to make sure
24 they have enough staff to carry this through and make this a
25 very important effort to minimize the differences over time.

1 CHAIRMAN POZEN: I just want to make sure I
2 understand. There are two different scenarios here. One is
3 we adopt the new standard. We set an effective date. We
4 then have a year or two transition period, and then we close
5 off the transition period, where we have done a review of
6 what happened during the transition period.

7 The second post-effective is for some rule that has
8 been out there for ten years, 20 years, and it has been
9 controversial. People have issues. That is a separate
10 process.

11 MR. KROEKER: Bob, maybe calling it a "transition
12 period" isn't -- we can think about the words. "Transition"
13 means so much at least to accountants. It could be a
14 learning and evaluation period. Just because "transition" is a
15 very sensitive word for accountants.

16 CHAIRMAN POZEN: We will work on those.

17 MR. BERESFORD: Bob, I think the second part, too,
18 wouldn't necessarily be standard specific. It would be more
19 like at some particular time, the FASB would say we would
20 like comments from users, preparers, auditors, whoever it
21 might be.

22 Are there some standards that have outlived their
23 usefulness or need to be fine tuned or replaced, whatever it
24 might be.

25 CHAIRMAN POZEN: Yes. Jeff?

1 MR. DIERMEIER: The way it reads right up at the
2 top, it makes it look like --

3 CHAIRMAN POZEN: What page are you on?

4 MR. DIERMEIER: 48, right at the top of the
5 proposal. The way it reads, it almost looks like the SEC
6 doesn't now encourage an objectives based approach, and
7 under SOX and the SEC's Staff Directive of October 2003, FASB
8 2004, "objectives oriented standard" is already defined.

9 I just think the wording needs to be altered there
10 a bit.

11 CHAIRMAN POZEN: Should increase its encouragement.

12 I think page 52, David.

13 MR. SIDWELL: Again, this is conceptual. We are
14 not asking -- this is not a final proposal at this point.

15 This is really when you get to the point of how is
16 a standard written. There is a lot going on in this area
17 already. We want to further think about this in terms of
18 what are the ingredients that should be considered when Bob
19 writes a standard.

20 CHAIRMAN POZEN: I know we have some time pressures
21 on Ed and Tom, so I do want to get to Subcommittee 1 and give
22 you guys a chance.

23 I know we have been going pretty strong here. I
24 think we can continue.

25 MR. EVANS: Bob, do we need to vote?

1 CHAIRMAN POZEN: Yes; sorry. Do we have a vote on
2 all of these proposals? Everyone who is in favor, say "aye."

3 (Chorus of ayes.)

4 CHAIRMAN POZEN: Anyone opposed?

5 (No response.)

6 CHAIRMAN POZEN: Okay.

7 MR. COOK: Bob, can I just make an observation or
8 ask the Subcommittee to think about this as they move this
9 forward?

10 This notion of economic reality keeps creeping in
11 from different places. I just think we ought to get an
12 uniform position. On page 53, we say "optimal accounting
13 standards should be a faithful presentation of economic
14 reality." I salute that. I couldn't think of any reason why
15 that's not a good idea, except that's not where we are today
16 in a large proportion of our existing standards.

17 I'd just like to point this out. I think I
18 mentioned it in a different forum. The definition of
19 "complexity," which is not your Subcommittee but it is our
20 over arching statement, "complexity is due to the difficulty
21 for users to understand economic substance."

22 That isn't because of complexity. That is because
23 GAAP doesn't purport to represent economic substance.

24 Preparers are besieged by complexity because they
25 don't know how to communicate economic substance.

1 I would suggest somebody would do this entire group
2 a service by addressing this question of economic substance
3 and saying something consistent about it.

4 We have said in our section don't count on the
5 judgment framework to rescue us from the absence of economic
6 substance because we are not going to be able to do that.

7 This says optimal standards should be a faithful
8 presentation of economic reality. I don't think -- I don't
9 have any objection to the statement, but I just don't think
10 it's consistent with where we are today.

11 MR. QUIGLEY: That was an effort to try to describe
12 a future statement.

13 MR. COOK: I understand. I'm just saying on
14 complexity, when we say complexity is the reason why people
15 aren't communicating economic substance, that is not
16 complexity. That is the standards don't require it. The
17 standards do not attempt in many instances to represent
18 economic substance.

19 CHAIRMAN POZEN: I think, Mike, you have
20 articulated well that point of view. We need to take a
21 consistent position.

22 MR. COOK: Try to find a common --

23 CHAIRMAN POZEN: I think Jim is right, he's talking
24 more in that critical stage, an ideal future stage.

25 MR. COOK: That's not your group as much as I guess

1 all of us. This definition of "complexity" needs a fresh
2 look if we are going to hinge it around the notion of
3 economic substance. It's not.

4 CHAIRMAN POZEN: Thank you very much, David. I
5 think there is a lot of meat there. With the Committee's
6 indulgence, we are going to push through here at the end.

7 We have both Ed and Tom. I think we are moving now
8 to page ten, as your first proposal. This is Subcommittee 1.

9 Tom, would you like to sort of kick it off?

10 SUBCOMMITTEE 1 - SUBSTANTIVE COMPLEXITY

11 MR. WEATHERFORD: First of all, to update the
12 Committee, we had a two day meeting in December where we
13 asked for input from both preparers, investors, as well as
14 the legal and accounting professions.

15 They pretty much confirmed the direction we were
16 headed but we were able to get input which we allowed to put
17 into our current proposals.

18 In addition to that, we are depleted today. We are
19 missing two of our members, so we need a depletion allowance
20 of some type. Sue is sick. Joe is working. You will have
21 to put up with the two CFOs on this.

22 We have focused on three main areas in terms of
23 avoidable complexity. The first is exceptions to general
24 principles. The second is bright lines, and the third is the
25 mixed attribute model.

1 The first one, exceptions to general principles, we
2 think there are four areas in which we are focusing, two
3 of those areas, we will have a definitive proposal today,
4 that is industry specific guidance, the second is alternative
5 accounting policies.

6 The second two, scope exceptions and competing
7 models, we are still in the discussion phase. At this point,
8 we really don't have anything to propose for that today.

9 I will go over those and then on the conceptual
10 side, on bright lines and mixed attribute models, Ed will
11 discuss that.

12 Our first proposal is around whether GAAP should be
13 based on activities rather than industries.

14 CHAIRMAN POZEN: This is on pages 10 and 11.

15 MR. WEATHERFORD: Sorry, this is on page ten.

16 CHAIRMAN POZEN: And 11.

17 MR. WEATHERFORD: We believe, although each company
18 thinks it is unique and each industry is unique in a way, the
19 economic objectives of obtaining revenue, achieving
20 profitability and generating cash are pretty much the same,
21 so there is no reason why GAAP should not support how these
22 numbers are created and supported.

23 Even though companies do feel that they are unique,
24 they can do this by the way they report the numbers in terms
25 of special key indices, but in terms of creating the revenue

1 or the profitability or the cash, we feel it should be a
2 consistent set of standards.

3 We think this is also important to investors
4 because we believe investors also are first among equals, not
5 only individual investors, but also many knowledgeable
6 investors today are very, very much confused by the different
7 standards that are out there.

8 It causes lack of comparability across industries
9 and even across companies in the same industries, you have
10 this issue.

11 We do believe that the first proposal should be
12 GAAP should be based on activities rather than industries.
13 This should be a phased in project where all new projects
14 undertaken separately by FASB or IASB should be scoped on the
15 basis of activity rather than industries, and then also with
16 any joint projects, and if possible, should include the
17 elimination of industry specific guidance in relevant areas
18 where they do seem to be conflicting.

19 In addition to that, we feel in conjunction with
20 its current codification effort, the FASB should add a
21 project to its agenda to remove or minimize existing industry
22 specific guidance that conflicts with generalized GAAP prior
23 to achieving full convergence.

24 That's our first proposal.

25 CHAIRMAN POZEN: There is a tiering there. Those

1 industry specific guidances that conflict with GAAP, second
2 of all, there are those that are sort of filling the vacuum,
3 like where there is no revenue recognition, those obviously
4 should wait until the general standard is done, and there are
5 those that just pretty much restate.

6 MR. WEATHERFORD: Exactly.

7 CHAIRMAN POZEN: The priority is the conflicting
8 guidance and we are looking for some sort of gradual process
9 over time.

10 Can we have comment on that? Jeff?

11 MR. DIERMEIER: You might need just a little
12 definition of what "activities" is for people who aren't
13 astute in kind of accounting-ese. And then "transactions."

14 MR. WEATHERFORD: It is similar to activity based
15 costing. It's the generation of revenue. It doesn't matter
16 whether you are an oil company or a software company, you are
17 generating revenue. You are recognizing it. How you defer
18 or recognize that revenue should not be based on different
19 accounting standards, but it should be based on the specific
20 key rules of what generates revenue.

21 CHAIRMAN POZEN: I think we can get that to be a
22 little better explained. Bob?

23 MR. HERZ: I agree with the basic thrust of this
24 recommendation.

25 CHAIRMAN POZEN: I've read three speeches in which

1 you have made this same point.

2 MR. HERZ: Yes, I've made this point. I think how
3 it gets from our point of view operationalized again is a
4 little bit path dependent.

5 A lot of the specific industry GAAP starts with
6 revenue, different revenue recognition models. We have a
7 major project with the IASB to create a single or small
8 number of basic recognition models across different
9 industries that would be more activity based. That is part
10 of it.

11 The rest of it again would be path dependent. If
12 people said, you know, we want U.S. GAAP here for the next 20
13 years or 15 years, we would say we would go through the
14 codification and re-do that. On the other hand, we would say
15 we really want to get to convergence. We would use the
16 codification as the point of figuring out probably how to
17 adopt the relevant IFRS standards in that particular area
18 that were not constructed in the same way that U.S. GAAP was.

19 MR. McCLAMMY: I think our main point was as you go
20 through this process, focus on the activities, and if someone
21 says our activity is unique, and therefore, for me, you need
22 to look at it differently, say aren't there other people that
23 have something that is very similar to that, to get rid of
24 this inconsistency. I think that was being illustrated in
25 another group as well.

1 CHAIRMAN POZEN: I think there is something on page
2 11 which sort of relates to IASB. I think it is a difficult
3 and non-trivial question, how you would actually implement
4 this. It is closely linked to how that goes.

5 We were trying to recognize that. Charles?

6 MR. HOLM: Maybe it's more of a question. How much
7 room is there for activity based implementation guidance? I
8 guess why I ask, it is clearly saying we want the guidance to
9 be more activity based and not industry based. That
10 certainly seems very reasonable.

11 By the same token, there is value to some
12 implementation guidance. I suspect it's gone overboard at
13 times, and I don't know how many pages we have in U.S. GAAP
14 now. I think David Tweedie has told me before.

15 Nonetheless, there is some room for implementation
16 guidance, perhaps most of it should be activity based, as
17 long as it is a reasonable level.

18 MR. McCLAMMY: That is our specific point. This
19 wasn't trying to address how much implementation guidance
20 there should be as much as if there is, it should not be
21 based on a particular industry as much as on the activity.

22 CHAIRMAN POZEN: Did you mean to say industry
23 guidance or industry implementation guidance? I'm not sure,
24 Charles.

25 MR. HOLM: Industry implementation guidance, which

1 I see as going away primarily.

2 CHAIRMAN POZEN: I think our sense is, and this may
3 not be that enthusiastic about it, when you take an activity
4 like loans, and we now have so many different entities that
5 make loans, of course, banks make loans, but there are lots
6 and lots of different groups, and we are trying to focus on
7 loan as an activity as opposed to banking --

8 MR. HOLM: I understand that and concur. There is
9 one sentence on page ten, maybe it's just a nit, it is the
10 paragraph right above the developed proposals, which says "To
11 the extent that such guidance interprets principles, it
12 should not be included in GAAP."

13 I think there is room for maybe that type of
14 guidance to be moved into activity based guidance rather than
15 being industry specific guidance.

16 CHAIRMAN POZEN: Which sentence is that?

17 MR. HOLM: The paragraph on page ten right above
18 the developed proposals, which could be read as we are just
19 eliminating guidance.

20 CHAIRMAN POZEN: Yes, it's overstated and we can
21 work on that. Any other comments on that?

22 Let me be clear. This sounds like a very
23 reasonable proposal but all hell's going to break loose when
24 all the industries -- I can assure you, this is an under
25 statement to say they think they are unique. I personally

1 come from the mutual fund industry, which definitely
2 considers itself unique.

3 This is a big change even gradually going forward.

4 MR. COOK: I just don't fully understand this
5 bullet on page 11, down toward the bottom. The placement of
6 that "prior to achieving full convergence."

7 "In conjunction with the current effort, the FASB
8 should add a project to its agenda to remove or minimize
9 existing specific guidance that conflicts."

10 I don't understand adding the phrase "prior to
11 achieving full convergence." Add it to the agenda prior to
12 convergence or get it done before convergence?

13 MR. WEATHERFORD: We are saying get it done before
14 convergence.

15 MR. HERZ: How we would do that would depend on
16 whether we are going all out for convergence or not.

17 CHAIRMAN POZEN: We probably want to play around
18 that. That may be better in connection with whatever plan
19 there is for full convergence or something. It's a good
20 point.

21 MR. McCLAMMY: I think the intent was the message
22 don't wait for convergence, go ahead and get this done.

23 CHAIRMAN POZEN: Maybe we want to fudge a little on
24 that issue until David's group has a chance to look at it.

25 Let's go on to page 14, to a similar proposal on

1 alternative accounting policies.

2 MR. WEATHERFORD: 2.2 is basically in concept
3 similar to 2.1, and we are proposing that GAAP should be
4 based on the presumption that formal accounting policy should
5 not exist and any new projects taken separately by FASB or
6 IASB should not provide additional optionality, except in
7 rare cases where it can be justified.

8 We feel that the same principles that relate to
9 specific industry guidance relate to alternative accounting
10 policies.

11 CHAIRMAN POZEN: If anything, this has been an area
12 of even more political sort of pushing and throwing. A lot
13 of these alternatives -- I think there are a very, very small
14 number which conceptually can be defended, most of these were
15 just people didn't want to take the change, so this
16 alternative.

17 We are recommending that this proposal go forward
18 and again, here is a case in which IFRS tends to have more
19 alternatives. If we are going to go down that road, we would
20 have to sort of squeeze that down.

21 Actually, IFRS is pretty good on industries, but
22 alternatives could actually be their Achilles Heel.

23 MR. McCLAMMY: We agreed just to do this one
24 prospectively and not to have a proposal, to have the FASB
25 look backwards.

1 MR. JONAS: Unnecessary diversity in reporting is
2 the enemy of financial analysis. I think this point, I
3 absolutely agree with.

4 I was surprised, therefore, to read the language
5 that directly followed the bolded language, and it is
6 specifically the one that says "Possible justifications for
7 retaining diversity are" and the first bullet says "I've got
8 two equally viable ways to go, both justifiable under users'
9 needs and the conceptual framework, so I retained both."

10 That answer surprises me. If I have two equally
11 valid answers, pick one. Why would we tolerate diversity
12 when we could avoid it and still get an answer that meets
13 users' needs at acceptable costs?

14 MR. WEATHERFORD: I think we are saying where there
15 are two that are equal, the objective is to get those two
16 into one, but at this point, we are not going to focus on
17 whether one is better than the other.

18 MR. JONAS: I'm sorry. I'm looking at the language
19 that says "Possible justifications for retaining diversity."

20 MR. WEATHERFORD: Right.

21 MR. JONAS: Why would that be a justification to
22 retain diversity, the fact that we have two possible answers?

23 CHAIRMAN POZEN: I think, and it may not be stated
24 as well as we should, I think the idea was that there is this
25 very small limited number of alternatives that actually have

1 a conceptual basis to it. Most of them have no conceptual
2 basis, so just in order of priority, that was a lower
3 priority.

4 MR. JONAS: I apologize to Tom. I didn't
5 understand his point. Now I see his point. Linda pointed it
6 out in the next paragraph. I apologize.

7 MR. McCLAMMY: You could run into some things where
8 you need multiple, but our strong point, maybe we should even
9 have it more in one of our bold statements, that you have to
10 have a sunset to it.

11 MR. JONAS: Right.

12 MR. McCLAMMY: You have to have a path to get rid
13 of it.

14 CHAIRMAN POZEN: Any more comments on that?

15 MR. HERZ: Could I ask a question?

16 CHAIRMAN POZEN: Yes, absolutely.

17 MR. HERZ: A difficult issue of management intent,
18 which I think you captured well here, but should there be a
19 recommendation, in re-framing the conceptual framework, do we
20 try to figure out whether or not management intent ought to
21 matter or not, and if so, where?

22 CHAIRMAN POZEN: I guess for better or worse, the
23 Subcommittee is punting on that issue.

24 MR. McCLAMMY: Right.

25 CHAIRMAN POZEN: I think if they can figure out

1 everything else here, and the problem is their view was that
2 it all depends on the facts and circumstances, context.

3 MR. HERZ: There is no doubt in the existing
4 accounting, it causes all sorts of alternatives and rings
5 fences around alternatives and exceptions. It is a huge
6 source of both implementation complexity, and I think
7 analytical complexity.

8 That doesn't mean the point about if your intent is
9 different, then it does change the nature of the transaction
10 might not be valid.

11 CHAIRMAN POZEN: Bob, we will put it at the back of
12 our list and when we finish everything else, we will get to
13 management intent.

14 I think we are now at -- if you want to just go
15 over pages 16 through 18, just to show where we are going on
16 the rest of these.

17 MR. McCLAMMY: Those were the only definitive. Do
18 you want to go ahead and vote on those?

19 CHAIRMAN POZEN: Yes, let's take a vote on those
20 two. All those in favor?

21 (Chorus of ayes.)

22 CHAIRMAN POZEN: Anyone dissenting, including
23 people on the phone?

24 (No response.)

25 CHAIRMAN POZEN: Okay. Maybe in the interest of

1 time, what we ought to do is just say that pages 16 through
2 18 really represent sort of other bases for exceptions in
3 GAAP, meaning other than industry specific guidance or
4 alternative treatments, and that the Subcommittee will be
5 looking at these going forward.

6 I don't think we have that much to say at this
7 time.

8 MR. McCLAMMY: No, we do not.

9 CHAIRMAN POZEN: Denny?

10 MR. BERESFORD: If I could, just two real quick
11 comments on the conceptual ones. Number one, the pro rata,
12 I'm not sure if it's proper to describe that as pro rata. I
13 think what you are really doing, for example, would be
14 recording the full present value of the lease and then
15 offsetting that with an asset.

16 It may be a pro rata representation of the total
17 value of the asset, but there may be a better way of
18 describing that. You are putting all of a certain kind of a
19 transaction in the financial statements.

20 The other comment is with respect to fair value,
21 this is really the only place that we cover fair value much
22 in our total report, and I wonder if you considered the
23 possibility of suggesting that the SEC or somebody else does
24 some sort of a study about whether fair value as it is now
25 imposed in a number of different financial accounting

1 standards really has provided more useful information to
2 investors and users.

3 CHAIRMAN POZEN: Let's just split that, because
4 there are two big subjects here. We are first looking at
5 bright lines, which is between 19 and 21.

6 MR. BERESFORD: I apologize.

7 CHAIRMAN POZEN: No, we will move quickly. The
8 bright line proposal here, I think we are all pretty
9 familiar, saying lease accounting, 89.9 percent, so the
10 thought was here that certain things could be used.

11 Ed, you may just want to explain it.

12 MR. McCLAMMY: Yes. Underneath that, where it says
13 to refer to proration recognition, and I think, Denny, that
14 gets back to your comment, that can be a discounted fair
15 value of your portion of that asset or your rights to that
16 asset, your liabilities?

17 MR. BERESFORD: It is really just recording
18 executory contracts, I think, is one way of looking at it.

19 CHAIRMAN POZEN: That was just a shorthand and
20 maybe it is not the best shorthand.

21 MR. McCLAMMY: Yes. The real key was to get away
22 from the all or nothing, that there are a lot of situations,
23 and leases is probably the most understood example, where
24 there is something between all or nothing that is probably a
25 lot better.

1 And it really has caused a lot of activity going
2 from a complexity standpoint, of people trying to work past
3 again that 90 percent, for example, in the lease accounting.

4 I think as we had said before, whole industries
5 have been set up to try to tweak it to the point that you are
6 on the right side of that line, and then a lot of litigation
7 happens to try to prove that you are really on the other side
8 of the line.

9 We think that is a preferable direction to go,
10 although we have more discussion to do on it.

11 The more we talked about that, we realized there
12 may be some situations where if you can't get there, you may
13 at least through additional disclosure or through some rules
14 of thumb and additional considerations come up with some
15 alternative proposals.

16 I think one of the areas, Tom, that we talked about
17 there was on consolidations.

18 CHAIRMAN POZEN: Now that we have seen a number of
19 large banks take back onto their balance sheet rather huge
20 so-called off balance sheet, I think it raises an issue about
21 what sort of disclosure there was, that Citibank actually had
22 \$50 or \$60 billion there.

23 Whether they had any contingent, informal or formal
24 liabilities, I think it is a pretty serious issue. This is
25 where disclosure might be a potential approach to this.

1 MR. McCLAMMY: That is kind of where we are on that
2 one currently. Obviously, it needs a lot more discussion to
3 get it flushed out.

4 We also added the 2.B underneath that on the
5 additional education. It's taking users, preparers and
6 auditors more in the direction of economic substance. The
7 term is there again.

8 This comment you probably could even put into the
9 camp of the future considerations. We really have not had
10 much dialogue around that one at this point at all.

11 CHAIRMAN POZEN: The question, just to do this in
12 an orderly fashion, beside Denny's comment, which I think is
13 good, does anyone else want to comment on this bright line
14 approach? I think it's pretty preliminary.

15 (No response.)

16 CHAIRMAN POZEN: Now we move to pages 25 through
17 27.

18 MR. McCLAMMY: Clearly, there is some very meaty
19 stuff on these two pages, of which we have had some
20 discussion, but still have a lot more work we need to do to
21 flush these out as well.

22 CHAIRMAN POZEN: Again, in the interest of time, to
23 really focus this, I think there are really two basic issues
24 here, one which is raised by Denny, and that is whether there
25 ought to be some sort of moratorium, and this word is

1 mentioned here, increase in fair value, until we get a sense
2 of whether or not this is really a useful exercise.

3 The second really goes to the whole mixed model and
4 moving toward a chunking of the income statement so that it
5 would reflect differences between whether it's core --

6 MR. McCLAMMY: Clearly, what we need to get worked
7 out on that, we had a lot of discussion in our last
8 Subcommittee meeting on that specific topic, and it became
9 clear that in people's minds, when you said "chunking," they
10 thought different things, or that the chunking was done
11 differently.

12 Was it by business events and financing events or
13 was it by measures that are more precise, medium precise,
14 very imprecise?

15 CHAIRMAN POZEN: We have FASB's approach on that.

16 Let's try to divide them. The first one is
17 something we have actually shied away from a little bit.
18 Perhaps we shouldn't, really sort of going whole hog at the
19 question of whether or not this whole movement toward fair
20 value is a useful one, or whether or not it has gone too far
21 or not far enough.

22 I guess one possibility, as Denny says, we could
23 suggest that somebody else other than us study it.

24 (Laughter.)

25 MS. GRIGGS: I like that one.

1 CHAIRMAN POZEN: I think we ought to have some
2 discussion. It's a pretty serious issue. Bob?

3 MR. HERZ: I think this is at the core or heart of
4 our conceptual framework, where you look specifically on
5 measurement, which has just started. That is what that is
6 designed to do, as to whether or not there ought to be a
7 single measurement attribute or multiple, what are the
8 criteria, all of that.

9 That has been watched on a global basis
10 essentially, a robust debate, and we have gotten already lots
11 of input. The CFA Institute has done a fairly large survey
12 and got a lot of responses from their members as to what they
13 think, but we have gotten obviously different points of view
14 from other people.

15 That is at the core of really thinking things
16 through. I think my own view is that -- I don't know if we
17 call it a moratorium or what -- that we would not be extending
18 fair value into measures into wholesale and to new areas
19 until we have resolved those issues on a conceptual basis.

20 If you want to endorse that --

21 CHAIRMAN POZEN: May I just ask you, is there
22 anything you think this Committee could do that would be
23 useful to you in that exercise?

24 MR. HERZ: There are a lot of heated debates. The
25 idea of getting better thought and better light around the

1 whole issue is just the key one.

2 CHAIRMAN POZEN: I just want to welcome comments
3 from anyone who wants to talk about that. Jeff?

4 MR. DIERMEIER: I just support what Bob says. I
5 think the whole subprime issue just highlights the value of
6 having things that are priced at a given point in time at a
7 certain level, that everybody basically has that information
8 available to them, so that people aren't kidding themselves,
9 and ultimately it protects us against the really big blow
10 ups.

11 You have even seen some of the European financial
12 organizations, I think, starting to wake up to the fact that
13 not marking things to market is a way to avoid a lot of
14 small inoculations but maybe cause death.

15 CHAIRMAN POZEN: Yes, Bob?

16 MR. HERZ: I think it dove tails also with our
17 financial statement presentation project, the chunking
18 project, in that I think historically this issue of the mixed
19 attribute model and fair values and all that, we have done a
20 horrible job collectively because we have mish-mashed
21 everything up that has different kinds of qualities.

22 I think the more modern thinking is that going with
23 economic substance clearly separates what I will call flows
24 from changes in marks, or other forms of re-measurement in
25 accounting.

1 We have all sorts of historic cost based accounting
2 that has all sorts of clips where you re-measure things and
3 all sorts of other estimates involved that are not that
4 transparent.

5 Part of this project is to segregate things that
6 are more transaction based and flows from these things that
7 are really estimates, whether it be fair value estimates
8 versus other types of estimates already embedded in
9 accounting.

10 CHAIRMAN POZEN: I think if Susan were here, she
11 would say that the thrust of the subcommittee's, or at least
12 where they are headed, direction is a combination of
13 saying let's have a moratorium on fair value until we can
14 work through all these issues, with a second statement that
15 says wherever that comes out, we ought to have an income
16 statement that allows users to distinguish between things
17 that are cash or accrued income versus those things which are
18 essentially paper profits based on fair value.

19 Right now, it's all, to use a technical term,
20 smushed together, and it is very hard to tell the difference.

21 I think that is where we are at the moment. I
22 don't know, Denny, it seems like they are pretty much doing
23 that. I don't know whether it's really useful for us to call
24 for a study of that.

25 I think it is a question of whether we are prepared

1 to call as a Committee for a moratorium on new fair value. I
2 don't know, Jeff, how you would feel from the user's point of
3 view.

4 MR. DIERMEIER: I'm pretty sure we would be very
5 concerned about that. It's an awfully complex subject. Bob
6 knows, a number of the things he was talking about earlier.

7 In terms of supporting the FASB/IASB presentation
8 project, I would see that as something this group would
9 support because it is going to take a while for that to
10 finish. It will be well beyond the period of time after this
11 Committee is long gone.

12 MR. HERZ: The other point, we have some industries
13 right now howling on physical commodities that we be clear
14 they should carry those at fair value. They believe the
15 current accounting is just not reflective of how they run
16 their activities there.

17 They have implored us to get on with a project that
18 would clarify that area, to move to fair value.

19 CHAIRMAN POZEN: I guess the question to pose here
20 is where this subcommittee is going now is essentially to
21 finesse the fair value issue itself and say let's leave it up
22 to FASB to figure out what should be fair value and what
23 shouldn't be, but second of all, to focus on the income
24 statement as a way to try to understand what FASB is
25 proposing and to try to provide a better presentation of the

1 income statement.

2 I know it can be chunked in a variety of different
3 ways, so that whatever is fair valued is clearly
4 distinguishable from things that are not fair valued.

5 That is sort of where we are. I think there is a
6 bit of reluctance on the subcommittee, and rightly so, to try
7 to tackle the whole issue of what should be fair valued and
8 not. It is being fully explored.

9 Are people comfortable with that?

10 MR. WALLISON: Just as a sort of historical point,
11 the American Assembly had a conference several years ago.

12 CHAIRMAN POZEN: American Assembly of?

13 MR. WALLISON: It's called the American Assembly.

14 CHAIRMAN POZEN: I don't know that particular
15 group.

16 MR. WALLISON: The American Assembly of the
17 American Assembly.

18 CHAIRMAN POZEN: I see. Who gets assembled when
19 they assemble?

20 MR. WALLISON: In this case, it was accountants and
21 then a few others. The idea was to deal essentially with
22 this issue, among others.

23 One of the things that they came up with was the
24 idea of changing the accountant's certification. They said
25 that the certification wasn't entirely accurate because a lot

1 of it, financial statements, is in part market value and in
2 part fair value by some sort of model, and in part, costs.

3 If you divided those things separately, what you
4 would come up with was something that was more accurate for
5 accountants, so that they would say they could certify as to
6 the things that were market value or cash and the things that
7 were valued in some other way, they would say is based on
8 costs or based on some kind of estimate.

9 That is something that this Committee might
10 consider.

11 CHAIRMAN POZEN: Mike, what do you think of that?

12 MR. COOK: I think I've heard this before in sort
13 of that format, and I think my response was that is not a
14 viable project for us to undertake in the time frame with the
15 scope of activity that we have for this Committee, but I
16 think the Treasury group looking at the viability of the
17 accounting profession and the future of the accounting
18 profession is absolutely the right place for that issue to be
19 taken up.

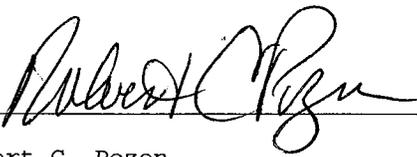
20 MR. McCLAMMY: In fact, we had that in our last
21 report at the last meeting, and based off the discussion, the
22 subcommittee decided to drop that topic.

23 CHAIRMAN POZEN: I think the answer is in the
24 allocation of items, this is now a Treasury item. I think
25 there is a sign of relief in certain circles that is so.

CERTIFICATION

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I hereby certify the accuracy of this record of the
proceedings of the SEC Advisory Committee on Improvements to
Financial Reporting.



Robert C. Pozen
Committee Chair



Date

Exhibit A

**Open Meeting of the
SEC Advisory Committee on Improvements to Financial Reporting**

**Multipurpose Room, Room L006, SEC Headquarters
Washington, D.C.**

Friday, January 11, 2008, Beginning at 9:30 A.M.

AGENDA

- I. Introductory Remarks – Robert Pozen, Committee Chairman
- II. International Considerations
- III. Discussion of Developments since November Meeting
 - A. Subcommittee 4 – Delivering Financial Information
 - B. Subcommittee 3 – Audit Process and Compliance
 - C. Subcommittee 2 – Standard-Setting Process
 - D. Subcommittee 1 – Substantive Complexity
- IV. Vote on Proposal to Publish Progress Report
- V. Next Steps and Future Timetable
- VI. Planning for March Meeting
- VII. Adjournment (expected no later than 3:30 pm)

Exhibit B

**ADVISORY COMMITTEE
ON IMPROVEMENTS TO
FINANCIAL REPORTING**

DRAFT DECISION MEMO

January 11, 2008

Advisory Committee
on Improvements to Financial Reporting

Draft Decision Memo

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CHAPTER 1: INTRODUCTION

In July 2007, the United States Securities and Exchange Commission (SEC or Commission) chartered the Advisory Committee on Improvements to Financial Reporting (Committee). The Committee's objective is to examine the U.S. financial reporting system to identify ways to improve it. To accomplish its objective, the Committee is focusing on ways to make information presented by U.S. public companies more useful and understandable for investors, while reducing the complexity of such information to investors, preparers, and financial professionals.

The Committee believes that financial reporting should provide information that aids users in making investment, credit, and similar resource allocation decisions.¹ However, some argue that over time, financial reporting has become a burdensome compliance exercise with decreasing relevance to users. This effect can be attributed, in part, to i) the fact that evolution of new business strategies and financing techniques stretches the limits of what the traditional reporting framework can effectively convey, and ii) an overly litigious culture that, arguably, results in financial reporting designed as much to protect against liability as to inform investors. As a result, the Committee believes 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 this context. The Committee proposes to apply the following definition of complexity during its deliberations on financial reporting.

Definition of Complexity

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

- (1) users 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 (GAAP) and communicate the economic substance of a transaction or event and the overall financial position and results of a company, and
- (3) other constituents to audit, analyze, and regulate a company's financial reporting.

¹Adapted 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*, issued on 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."

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

Causes of Complexity

Significant causes of complexity include (not an all-inclusive list):

- (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:
 - Opposing points of view, such as lobbying on both sides of a debate, that are taken into account when developing standards. Most importantly, attempts by public companies to smooth amounts that are not smooth in their underlying economics contribute to complexity.
 - 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 over time;
 - 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 challenging for particular fact patterns.
- (5) Audit and regulatory systems that challenge the use of professional judgment – The risk of litigation and of being “second-guessed” creates significant consequences for failing to communicate unbiased financial information appropriately.
- (6) Educational shortcomings – Undergraduate and graduate education in accounting have traditionally emphasized the mechanics of double-entry bookkeeping, which favors the use of detailed rules rather than the full understanding of relevant

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principles. The same approach is evident in the CPA 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 a user, 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 users 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.

The Committee observes 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. The Committee's focus is on avoidable complexity, with an emphasis on improvements that are feasible in the near term.

More specifically, the Committee's charter identifies the following areas of inquiry to make financial reporting more useful and understandable for investors:

- The current approach to setting financial accounting and reporting standards, including (a) the principles-based vs. rules-based standards, (b) the inclusion within standards of exceptions, bright lines, and safe harbors, and (c) 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; and
- 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.

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Upon conclusion of the Committee's work (and possibly at interim dates), the Committee will provide written recommendations to the Chairman of the SEC on how to improve the financial reporting system in the U.S. These recommendations may cover many aspects of the financial reporting system for the SEC to consider, including recommendations that involve the Financial Accounting Standards Board (FASB), the Public Company Accounting Oversight Board (PCAOB), and other appropriate organizations.

In order to maximize the benefits of this Committee, it intends to issue a limited number of recommendations. The Committee intends for the recommendations to be doable; that is, they will be adoptable by administrative action and not require legislation. The Committee also intends for the recommendations to be focused. It acknowledges that financial reporting involves myriad aspects and does not expect to address every issue. Instead, the Committee seeks to focus on those areas where there is a consensus that a problem exists and where it is feasible to find ways to implement improvements. As part of this focus, the Committee has limited its deliberations to matters involving SEC registrants. While financial reporting matters and, more specifically, GAAP, similarly apply to private entities, including nonprofit organizations, the Committee has taken this approach in its role as an advisory committee to the SEC.

The Committee has also focused its scope as it relates to international matters. The Committee notes that the SEC recently adopted rules to no longer require a U.S. GAAP reconciliation for foreign private issuers reporting under IFRS as issued by the 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. The Committee has proceeded on two premises: (1) that, despite any potential actions by the Commission to permit IFRS reporting by domestic issuers, U.S. 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 U.S. GAAP and IFRS will continue. As a result, the Committee believes it is productive to make recommendations on improving U.S. GAAP, as well as the related processes at the FASB, the PCAOB and the SEC. At the same time, the Committee will point out how its recommendations can be coordinated with the work of the IASB and the development of IFRS, with the objective of promoting convergence.

To facilitate the forming of these recommendations, the Committee has created subcommittees which report to the Committee for full discussion and deliberation. The subcommittees are listed below.

- I. Substantive Complexity
- II. Standard-Setting Process
- III. Audit Process and Compliance
- IV. Delivering Financial Information

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Matters related to international coordination will be addressed, as appropriate, as part of the Committee's deliberations beginning in 2008.

The purpose of this draft decision memo is to present the Committee's developed proposals, conceptual approaches, and future considerations based on the Committee's work to date. Developed proposals are sufficiently formed so that, shortly after approval at this meeting, they will be formally submitted to the Commission. Conceptual approaches differ from developed proposals in that conceptual approaches represent the Committee's initial discussions and leanings on a particular subject, but still require significant additional deliberation prior to formalization into a developed proposal. Future considerations represent areas where deliberation is still pending.

Questions for the Committee:

- 1.1) Do you agree with the proposed definition of complexity? Are there any revisions you would recommend?
- 1.2) Have the most significant causes of complexity been identified? If not, what other causes should be considered? How might they be addressed?

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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

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individual line items on the financial statements. The Committee intends to pursue these topics in 2008. Lastly, while deliberations have been conducted primarily in the context of U.S. GAAP, the Committee believes that its analyses and proposals are similarly applicable under IFRS.

Questions for the Committee:

2.1) Do you agree with the scope in the area of substantive complexity? Are there any areas you would recommend adding, removing or revising?

II. Exceptions to General Principles

II.A. Industry-Specific Guidance

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 (e.g., Statement of Position 97-2, *Software Revenue Recognition*), and (3) industry practices not specifically addressed or based in GAAP. Industries covered by this guidance include, but are not limited to, insurance, utilities, oil and gas, mining, cable television companies, financial institutions, real estate, casinos, investment companies, broadcasters, and the film industry. Refer to Appendix B for specific examples.

Industry-specific guidance can be categorized in one of the following:

- Guidance that is consistent with generalized GAAP – for example, certain guidance in AICPA Accounting and Auditing Guides is issued to assist preparers in interpreting and applying existing, generalized GAAP.
- Guidance that 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 up-front 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, SEC Staff Accounting Bulletin (SAB) 104, *Revenue Recognition*, (as codified in SAB Topic 13) which provides more generalized guidance, indicates this practice is inappropriate unless it is specifically prescribed elsewhere (such as SFAS No. 51). Therefore, similar activities like up-front fees for gym memberships are not afforded equal treatment.
- Guidance for which no generalized GAAP exists – for example, SoP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type*

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Contracts, discusses revenue and cost recognition in areas such as the construction industry, due to the absence of a general revenue recognition standard.

Industry-specific guidance has developed for a number of reasons, including:

- A lack of general standards in certain areas of GAAP (e.g., a single comprehensive revenue recognition standard).
- The activities of multiple standard-setting organizations.
- A desire by some to customize accounting standards for allegedly “special” transactions and user needs (each industry believes it is unique).
- A desire by some, including preparers, users, standard-setters, and regulators, to enhance uniformity throughout an industry.
- A tendency by industries to develop their own practices in the absence of applicable authoritative literature, coupled with the documentation of such practices by standard-setting organizations (i.e., documentation of what preparers are doing rather than consideration of what they should be doing).

Industry-specific guidance contributes to avoidable complexity in the following ways:²

- Incomparable and inconsistent reporting, such as:
 - Reduced comparability across industries, if conflicting accounting models are used for transactions with similar or identical economic substance.
 - Improper analogizing to industry standards in order to achieve desired results or to require a more conservative accounting treatments (e.g., by auditors).
 - Diverse conclusions as to whether similar companies are within the scope of specific guidance. This issue becomes problematic for diversified companies who may be involved in a number of different industries with conflicting industry-specific guidance.
- Unnecessarily increasing the volume of accounting literature. This volume, in turn, may result in:
 - Increased costs of implementing accounting literature.
 - Increased costs in maintaining accounting literature and more expansive standard-setting.
 - Increased costs of training accountants and retaining industry experts.

² As noted previously in the 2003 SEC report to Congress on the adoption in the United States of a principles-based accounting system:

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 standards 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.

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- Complexity for users in understanding the variety of accounting and disclosure.
- Hindering more wide-spread use of XBRL, as it increases the number of different data tags that need to be created, maintained, and properly used in information delivery.

On the other hand, industry-specific guidance may alleviate complexity in the following ways:

- By allowing industry reporting to better meet the specific user needs in that industry.
- By enhancing comparability across entities within an industry.
- By depicting important differences in the economics of an industry, particularly where application of a generalized principle may not result in accounting that is representationally faithful to a transaction's economic substance.
- By developing guidance where it is otherwise lacking in generalized GAAP.
- By simplifying or reducing the amount of guidance a preparer in an industry would need to consider, even though it might increase complexity across industries generally.
- By addressing prevalent industry issues quickly. Specifically, industry-specific guidance may be easier to issue on an accelerated basis due to its narrower audience than that of generalized GAAP.

The Committee acknowledges that industry-specific guidance has merit in certain situations, such as (1) where it interprets, rather than contradicts, principles and (2) where the activities in question are legitimately different (which are expected to be rare). However, the Committee believes that decreasing the amount of industry-specific guidance would reduce avoidable complexity. In this regard, to the extent that such guidance interprets principles (i.e., relates to implementation), it should not be included in GAAP. 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.

Developed Proposals

Based on the above considerations, the Committee has developed the following proposals:

Developed Proposal 2.1: *GAAP should be based on activities, rather than industries.*

- *Any new projects undertaken separately by the FASB or IASB should be scoped on the basis of activities rather than industries.*
- *Any new joint projects between the FASB and the IASB should be scoped on the basis of activities rather than industries, and should include the elimination*

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of existing industry-specific guidance in relevant areas as a specific objective of those projects, unless in rare circumstances, retaining such guidance can be justified.

As described above, one cause of industry-specific guidance is the absence of on-point, generalized GAAP. As generalized GAAP is developed, the Committee believes that industry-specific guidance should be eliminated.

Nevertheless, the Committee acknowledges that cost/benefit considerations might justify industry-specific guidance in limited situations. For example, cost/benefit considerations may 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 FASB should work with the relevant industries to identify long-term ways to phase out industry-specific guidance with as little cost as possible. In addition, the FASB should provide sufficient time to allow companies to transition to generalized GAAP, to help reduce the costs of transition.

From an international perspective, the Committee notes that IFRS currently contains less industry-specific guidance than U.S. GAAP and that such guidance focuses more on the nature of the activity (e.g., agriculture, insurance contracts, exploration and evaluation of mineral resources). Nonetheless, the IASB should be mindful of this recommendation, if adopted, as it continues to develop a more comprehensive body of standards. Further, if this recommendation is adopted, the IASB should also ensure that any future industry-specific (i.e., activity-based) guidance is limited to activities whose economics are legitimately different from other business activities. Otherwise, the Committee believes specialized accounting for only certain subsets of similar activities will create avoidable complexity.

- ***In conjunction with its current codification effort, the FASB should add a project to its agenda to remove or minimize existing industry-specific guidance that conflicts with generalized GAAP prior to achieving full convergence.***

The Committee has observed the FASB's codification project can be used to divide existing industry-specific guidance into one of three categories:

- a. Guidance that conflicts with generalized GAAP
- b. Guidance for which there is no generalized GAAP on point
- c. Guidance which duplicates generalized GAAP

The Committee believes efforts to reduce existing industry-specific guidance should focus primarily on Category a. above. Further, as new, generalized guidance is issued, including that which is issued through the convergence process, the SEC staff should eliminate its industry-specific guidance in those areas, if any. Please refer to chapter 3 of

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this report for the relative priority on the FASB's agenda of this proposal to reduce specialized accounting.

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

Questions for the Committee:

- 2.2) Do you agree with the presumption of basing GAAP on activities, rather than industries? If not, please explain why you believe industry-scoped accounting standards are preferable.
- 2.3) Do you agree with the developed proposal to minimize future industry-specific guidance? What revisions, if any, would you suggest?
- 2.4) Do you agree that industry-specific guidance which conflicts with generalized GAAP (category a. guidance above) is best addressed by adding a separate project to retroactively address such conflicts? Or are constituents better served by addressing conflicts in the context of new standard-setting projects?

II.B. Alternative Accounting Policies

Background

Alternative accounting policies refer to optionality in GAAP. The following discussion addresses formally-promulgated options in GAAP (i.e., it does not address choices available to preparers at more of a practice / implementation level³). Examples of optionality in GAAP include, but are not limited to: (a) the indirect vs. the direct method of presenting operating cash flows on the statement of cash flows, (b) the application of hedge accounting,⁴ (c) the option to measure certain financial assets and liabilities at fair value, (d) the immediate or delayed recognition of gains/losses associated with defined benefit pension and other post-retirement employee benefit plans, and (e) the successful

³An example is determining the depreciation method that most accurately reflects the pattern of consumption in a particular fact pattern—straight-line, double-declining balance, etc.

⁴The Committee has 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, the Committee generally feels 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 pro rata approach versus an all or nothing approach). The Committee is also aware of the FASB's derivatives project in this area and is generally supportive of its progress.

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efforts or full cost accounting method followed by oil and gas producers. Refer to Appendix B for additional examples.

Alternative accounting policies arise for a number of reasons, including:

- Circumstances where the pros and cons of competing policies may be balanced and thus, not result in a single, clearly preferable approach.
- Political pressure results in standard-setters providing for a preferred and an alternative accounting method.
- Administrative convenience of the preparer (e.g., cost-benefit considerations).
- A portrayal of differences in management intent.

Alternative accounting policies contribute to avoidable complexity in the following ways:

- Incomparable and inconsistent reporting, such as:
 - Reduced comparability across companies, if identical activities are accounted for differently.
 - Accounting that is less reflective of economic substance, to the extent that alternative accounting policies are based on political pressure.
 - Differences in accounting policies selected by preparers to achieve the most favorable accounting treatment.
- Unnecessarily increasing the volume of accounting literature to address each alternative accounting policy.

On the other hand, alternative accounting policies may alleviate complexity in the following ways:

- 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.
- By developing alternatives more quickly than a final “perfect” standard and minimizing the effect of other unacceptable practices. In other words, alternative accounting policies may function as a short-term fix on the road to ideal accounting (evolution of accounting theory).

While the Committee believes that the elimination of alternative accounting policies would reduce avoidable complexity, it acknowledges that such alternatives may have merit in certain circumstances. Accordingly, any recommendation should allow for these circumstances, which are articulated below.

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Management Intent

Some alternative accounting policies are based on management intent.⁵ Management intent is a present assertion about management's plans for future courses of action.⁶

The Committee has 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 a 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 of the use of management intent 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 while management intent is subjective and could change, this characteristic is no different than 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, the Committee has determined that accounting based on management intent is too dependent on facts and circumstances to feasibly address within the Committee's timeframe.

Developed Proposals

Based on the above considerations, the Committee has developed the following proposals with respect to alternative accounting policies, other than those arising from management intent:

Developed Proposal 2.2: GAAP should be based on a presumption that formally promulgated alternative accounting policies should not exist.

- ***Any new projects undertaken separately by the FASB or IASB should not provide additional optionality, unless in rare circumstances, it can be justified.***

⁵ For example, SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities*, allows management to classify certain debt instruments as either held-to-maturity, available-for-sale, or as a trading security based on the company's intent and ability with respect to the holding period of its investment. The financial statement treatment differs for all three categories.

⁶ The definition of management intent and certain other concepts in the discussion of alternative accounting policies are adapted from a 1994 FASB Special Report: *Future Events: A Conceptual Study of Their Significance for Recognition and Measurement*.

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- ***Any new joint projects between the FASB and the IASB should not provide additional optionality, but 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.***

Possible justifications for retaining alternative accounting policies include:

- Multiple accounting alternatives exist that are consistent with the conceptual framework, and none are determined to provide significantly better information to investors than others.
- An alternative or interim treatment can be developed more quickly than a final “perfect” standard, minimizing the effect of other unacceptable practices (evolution of accounting theory).

In the event one or both of the justifications above applies, the Committee believes that:

- The provision of alternative accounting principles should be coupled with a long-term plan to eliminate the alternative(s) through the use of sunset provisions.
- The effect of applying the alternative policy not selected by the company should be clearly and succinctly presented, (i.e., either through financial statement presentation or footnote disclosure).

From an international perspective, the Committee notes that IFRS currently permits numerous alternative accounting policies. While the Committee acknowledges the IASB’s efforts in reducing some of these alternative treatments, the Committee nonetheless believes that the IASB, like the FASB, should be mindful of this recommendation, if adopted, and seek to eliminate alternatives as part of its standard-setting projects.

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

Questions for the Committee:

- 2.5) Do you agree with the presumption of minimizing alternative accounting policies? If not, please describe the circumstances in which they are preferable.
- 2.6) Do you agree with the developed proposal to reduce alternative accounting policies in future standard-setting activity? What revisions, if any, would you suggest?

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- 2.7) Do you agree that reducing existing alternative accounting policies is best addressed in the context of future standard-setting? Or, are constituents better served by adding a separate project to standard setters' agendas to retroactively address such alternatives?
- 2.8) Do you believe that the issue of accounting based on management intent is so dependent of facts and circumstances that it is not feasible to address within the Committee's duration?

II.C. Scope Exceptions in GAAP Other Than Industry-Specific Guidance⁷

Background

Examples of scope exceptions in GAAP other than industry-specific guidance include:

- 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*.
- Business scope exception to the applicability of FIN 46R, *Consolidation of Variable Interest Entities*, subject to certain criteria.
- Application of SFAS No. 157, *Fair Value Measurements*, to share-based payment transactions.

Scope exceptions contribute to complexity because they result in different accounting for similar activities, require detailed analysis 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, the evolution of accounting theory discussed above, and the magnitude of change that would result from eliminating or reducing them.

Future Considerations

The Committee intends to deliberate this issue subsequent to the January 11, 2008 meeting.

⁷ The Committee has limited its focus to scope exceptions, while acknowledging there are other types of exceptions in GAAP. This limited approach was considered appropriate in light of the Committee's short duration.

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Questions to be Subsequently Considered by the Committee:

- 2.9) Do you believe that scope exceptions in GAAP other than industry-specific guidance contribute to complexity? Why or why not?
- 2.10) How significant would potential unintended consequences of eliminating scope exceptions be? Consider for example, the normal purchases and normal sales exception in SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
- 2.11) In what circumstances can scope exceptions be justified? Conceptually, how stringent should a presumption against scope exceptions be, if at all?
- 2.12) Please describe examples where scope exceptions result in accounting that is more representationally faithful than applying the related general principle.

II.D. Competing Models

Background

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 models for asset impairment testing such as inventory, goodwill, and deferred tax assets, etc.
 - 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

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- 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 are 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.
 - Different models for revenue recognition in the absence of a general principle.
 - Different models for derecognition of a pension or other post-retirement benefit obligation liability via settlement, curtailment, and negative plan amendments compared to derecognition of other liabilities on the basis of legal extinguishment.

Competing models contribute to 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, the evolution of accounting theory discussed above, and the magnitude of change that would result from eliminating or reducing them.

Future Considerations

In future deliberations, the Committee intends to explore the role of competing models in increasing avoidable complexity. The Committee will also explore, as discussed in chapter 3, the relationship between these competing models and the FASB’s conceptual framework.

Questions to be Subsequently Considered by the Committee:

- 2.13) Do you believe that competing models in GAAP contribute to complexity? Why or why not?
- 2.14) What would the consequences be of a recommendation to minimize such competing models?
- 2.15) In what circumstances can different models for similar types of transactions or events be justified?
- 2.16) Please describe examples where different models are necessary to result in representationally faithful accounting.

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III. Bright Lines

Background

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

Quantified thresholds include hard-and-fast cutoffs, rules-of-thumb, and presumptions 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 two quantitative tests,⁸ where a mere 1% difference in the results of the quantitative tests leads to very different accounting.

Pass/fail tests are similar to quantitative thresholds in that they result in recognition on an all-or-nothing basis. However, 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 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.

Refer to Appendix B for additional examples.

Bright lines arise for a number of reasons, including:

- An effort to drive comparability across companies.
- Convenience for preparers, auditors, and regulators because they reduce the amount of effort that would otherwise be required in applying judgment (i.e., the effort in understanding a transaction, debating potential accounting applications, and documenting that judgment) and the belief that they reduce the chance of being second-guessed.
- 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.

⁸ Specifically, SFAS No. 13, *Accounting for Leases*, requires that leases be classified as capital leases and recognized on the lessee's balance sheet where (a) the lease term is greater than or equal to 75% of the estimated economic life of the leased property or (b) the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of the fair value of the leased property, among other criteria.

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- Efforts to curb abuse. For example, some argue that sole reliance on judgment may result in aggressive accounting practices, such as revenue recognition where sufficient supporting evidence may not exist.

Bright lines contribute to avoidable complexity in the following ways:

- Incomparable and inconsistent reporting, such as:
 - Accounting that is not representationally faithful to the economic substance of the arrangement, particularly due to the all-or-nothing recognition described above.
 - 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.
 - Structuring opportunities to achieve a specific financial reporting result. For example, whole industries have been developed to create structures to work around lease and hedge accounting rules.
- Unnecessarily increasing the volume of accounting literature. This volume:
 - May result from standard-setters and regulators attempting to curb abuse from structured transactions that result from bright lines by developing additional guidance.
 - May require additional expertise to account for certain transactions, which increases the cost of accounting and the risk of restatement.

On the other hand, bright lines may alleviate complexity in the following ways:

- By reducing judgment, which may limit aggressive accounting policies.
- By enhancing perceived uniformity across companies.
- By providing convenience, as discussed above.
- By limiting 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 more timely. In other words, narrowly-scoped guidance and the bright lines that accompany them may function as a short-term fix on the road to ideal accounting (evolution of accounting theory).

Conceptual Approach

The Committee is still in the process of debating when, if at all, bright lines are justified in accounting literature. The Committee notes that even if standard-setters limit the issuance of bright lines, audit firms and other parties would likely continue to create non-authoritative guidance. As such, any 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 the Committee's consideration of a professional judgment framework, as discussed in chapter 4, and the

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Committee's consideration of interpretive implementation guidance and transition to and design of new standards, as discussed in chapter 3.

In addition, the Committee will continue to explore the following conceptual approaches:

Conceptual Approach 2.A: *The Committee is 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:*

- *Pro rata accounting - The Committee uses the term “pro rata accounting” to refer to proportional recognition, rather than the current all-or-nothing recognition approach. For example, consider a lease where 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 pro rata accounting, a lessee would recognize an asset for its right to use the machine (rather than an asset for a proportion of the asset) at approximately \$40⁹ 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 – The Committee recognizes that pro rata accounting is not universally applicable. In those cases, enhanced disclosure may be more appropriate. The Committee has yet to define the possible scope of pro rata accounting and/or enhanced disclosure, but it may extend to areas such as leases, consolidation policy and off-balance sheet activity.*
- *Rules-of-thumb coupled with additional considerations – The Committee uses the phrase “rules-of-thumb coupled with additional considerations” to refer to a less stringent use of bright lines, where professional judgment factors into an accounting analysis. The Committee will also consider rules-of-thumb coupled with additional considerations in situations where pro rata accounting may not be applicable.*

Conceptual Approach 2.B: *Further, the Committee is considering a recommendation related to the education of students, as well as to the continuing education of users, preparers and auditors, etc. The recommendation would encourage understanding of the economic substance and business purposes of transactions, in contrast to mechanical compliance with rules without sufficient context.*

⁹ 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 pro rata accounting may be an asset's estimated useful life, future cash flows or the share of a company's liabilities in a structured investment vehicle. The Committee is planning additional deliberations in this regard.

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Question to be Subsequently Considered by the Committee:

- 2.17) Some have argued that bright lines in U.S. GAAP result in structuring opportunities. Are structuring opportunities under U.S. GAAP more prevalent than under IFRS, which provides more generalized guidance in certain areas (e.g., lease accounting, revenue recognition, new basis / push down accounting, consolidations)?
- 2.18) Under what circumstances would requirements based on each of the following be appropriate:
- Bright lines
 - Pro rata accounting
 - Additional disclosure
 - Rules-of-thumb coupled with professional judgment?
- 2.19) What other alternatives should be considered as viable alternatives to bright lines?

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

Background

As previously noted, the mixed attribute model is one where 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 the recognition of some adjustments to carrying amounts in earnings and others in comprehensive income.

Examples of accounting standards that result in mixed attribute measurement include:

- SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which 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*, which requires certain investments to be recognized at fair value and others at amortized cost.

As discussed earlier, some have advocated mandatory and comprehensive use of fair value as a solution to the complexities arising from the mixed attribute model. However, the use of fair value contributes to avoidable complexity in the following ways:

- Incomparable and inconsistent reporting, due to:

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- The lack of a single set of generally accepted valuation standards for financial reporting purposes.
- Inputs to fair value models that are not easily verifiable. Consequently, according to some, there is too much subjectivity in the development of fair values, which significantly impacts the auditability of the numbers.
- Significant variance in the quality, skill, and reports of valuation specialists. Preparers have limited ability to assess this variety. Further, there is no mechanism to ensure ongoing quality, training, and oversight of valuation specialists.
- Financial reporting standards that are difficult to apply in practice
 - Some preparers' knowledge of valuation methodology is limited, requiring the use of valuation specialists, which results in additional expense.
 - Auditors often also require valuation specialists to support the audit. Some view the need for these valuation specialists as a duplication of efforts, at the expense of the preparer.
 - The effort and elapsed time required to implement and maintain mark-to-model fair values would be significant whether performed internally or by valuation specialists.
- Unnecessarily increasing the volume of accounting literature:
 - Some entities question whether investors are averse to volatility or hold management responsible for unfavorable results created by volatility from markets that management does not control. Consequently, entities have demanded exceptions from the use of fair value in financial reporting, resisted the use of fair value in financial reporting, and/or entered into transactions that they otherwise would not have undertaken to limit earnings volatility. These actions have resulted in an unnecessary increase in the volume of accounting literature.
- Impact on audit and regulatory systems
 - There is concern about second guessing by auditors, regulators, and courts in light of the many judgments and imprecision involved with fair value estimates.
- Making information delivery more difficult
 - Some users may not understand the uncertainty associated with measurements based on fair value (i.e., that they are merely estimates and in most instances lack precision), including the quality of unrealized gains and losses arising from changes in fair value.
 - Some question whether the use of fair value may lead to counter-intuitive results. For example, an entity that opts to fair value its debt may recognize a gain when its credit rating declines.
 - Some question whether the use of fair value for held to maturity investments is meaningful.
 - Preparers view disclosure of some of the inputs to the assumptions as sensitive and competitively harmful.

On the other hand, the use of fair value may alleviate complexity in the following ways:

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- By providing users with the same information as management, to the extent management makes decisions based on fair value.
- By improving the relevance of information in many cases, as historical cost is not meaningful for certain items.
- By enhancing consistency, such as:
 - 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.
 - Mitigating the need for detailed application guidance explaining which instruments must be recorded at fair value.
 - Helping to 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.
- By eliminating certain 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 the Management Intent section 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.

The Committee acknowledges the view that a complete transition to fair value would alleviate avoidable complexity resulting from the mixed attribute model. However, the Committee also recognizes 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 its work.

In light of its limited duration, the Committee recognizes it may not independently develop a comprehensive measurement framework, but plans to provide input to the FASB's project in this area (discussed below). As a result, the Committee believes that recommendations requiring a consistent measurement framework and better communication of measurement attributes would more feasibly alleviate 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.

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Conceptual Approach

Based on the above, the Committee will continue to explore the following conceptual approaches:

Conceptual Approach 2.C: Measurement framework – While the Committee may not be able to comprehensively address when fair value is the appropriate measurement attribute, it understands that the FASB’s conceptual framework project includes a measurement phase. The Committee intends to study this project further and is considering recommending 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 2.D: Moratorium – Due to implementation complexities, as noted above, the Committee is considering whether the FASB should refrain from issuing new standards and interpretations that require the expanded use of fair value in areas where it is not already required, until completion of the measurement framework. The Committee will also consider whether exceptions to this moratorium should be provided to facilitate necessary improvements to certain complex standards, such as SFAS No. 133 and SFAS No. 140.

Conceptual Approach 2.E: Grouping in Financial Statement Presentation – The Committee believes 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. The Committee believes that such a grouping would be more understandable to users, particularly as it would more clearly delineate the nature of changes in income (e.g., volatility, changes in estimate, business activity, etc.). This presentation might also help users assess the degree to which management controls each income item.

As part of its financial statement presentation project, the FASB has tentatively decided to segregate the financial statements into business (further divided into operating and investing) and financing activities. The 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.

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The Committee intends to study this project further and consider whether it would address the Committee’s leanings in this area and sufficiently facilitate users’ understanding of fair value.

Conceptual Approach 2.F: Additional Disclosure – *The Committee has identified potential areas for additional disclosure to more effectively signal to users the level of uncertainty associated with fair value measurements in financial statements. Specifically, the Committee notes that in some cases, there is no “right” number in a probability distribution of figures, some of which may be more fairly representative of fair value than others. Potential areas 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 vs. that of the entire market.*

The Committee acknowledges uncertainty also exists in other measurement attributes, such as historic cost, which may warrant similar disclosure.

Conceptual Approach 2.G: Disclosure Framework – *The Committee seeks to balance additional disclosure requirements, including, if any, those under conceptual approach 2.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 users 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 Committee’s efforts and future standard-setting activity, the Committee is considering recommending (1) that the FASB 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 piece-meal 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 standards are issued.*

Questions for Subsequent Consideration by the Committee:

- 2.20) Do you agree with the intention to refrain from determining the specific circumstances in which fair value should be used and, instead, primarily focus on ways to better communicate measurement attributes and the use of fair value to investors?

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- 2.21) Do you agree with the intention to refrain from addressing implementation issues, such as whether there is a need for valuation-related standard-setting and regulation?
- 2.22) What key elements should a measurement framework incorporate?
- How much weight should be placed on relevance vs. reliability?
 - Should a measurement framework prescribe a consistent measurement attribute for similar activities or similar assets / liabilities?
- 2.23) Do you agree with a full or partial moratorium on future standards that require or permit the use of fair value until the measurement framework is complete? If you do not believe a full moratorium is appropriate, what is the proper degree, if any?
- 2.24) Do you believe grouped financial statement presentation will be effective in reducing concerns about the mixed attribute model and the use of fair value? If not, what alternatives should be considered?
- 2.25) Do you believe the additional disclosure described above, as applicable, should be applied to other measurement attributes, such as historic cost? Why or why not?
- 2.26) Do you believe disclosure of company-specific projections used in fair value estimates, such as future revenue streams, are appropriate? How do concerns about the company harming its competitive position in the market factor in?
- 2.27) What additional disclosures would you recommend to address concerns and confusion due to the current mixed attribute model?
- 2.28) What specific improvements would you recommend to the FASB's current piece-meal approach to establishing disclosure requirements? To the extent that you believe a disclosure framework would improve the FASB's current approach, what key elements should such a framework incorporate?
- 2.29) Do you agree with the view that the SEC should develop a process to regularly evaluate and, as appropriate, update its disclosure requirements as new standards are issued? Should the Committee identify specific indicators as to when SEC disclosure requirements are justified in addition to or in lieu of FASB disclosure requirements? If so, what indicators would you recommend?

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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:

- 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

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holes and prevent abusive application of the accounting standards. This motivation was often driven by the desire of issuers to achieve certain earnings results or by the promises of sponsors that undertaking certain transactions would result in a particular accounting result.

Historically, interpretative implementation guidance has proliferated from a variety of sources and, intentionally or not, become an additional source of U.S. GAAP that may add to the complexity in the financial reporting system, especially when questions exist about its authoritative nature or conflicts exist between interpretations. In addition, the fear of having reasonable, good-faith judgments second-guessed sometimes causes preparers, auditors and regulators to engage in what could be termed “defensive accounting and auditing,” which is the practice of requesting more rules and interpretive implementation guidance. Such defensive accounting and auditing may further exacerbate the problem.

The Committee sets forth a number of proposals that serve to underscore the pre-eminence of the user perspective in designing and administering a well-designed and effective system of financial reporting. Using this perspective as a keystone will serve as a bulwark against the self-interest of those constituencies with a vested stake in a particular accounting treatment. In its creation, the founders of our modern accounting system equated maintaining balance amongst the different stakeholders as an important means of maintaining fairness in the system. The Committee believes that the system will be best served by recognizing the interests of users/investors as the foremost stakeholder when competing interests are unable to be completely aligned.

This chapter presents a number of developed proposals and conceptual approaches intended to alleviate some of the aforementioned concerns. In general, the design of the U.S. financial reporting system and the roles that each participant plays are largely appropriate, but the behavior of each participant has been impacted by the current regulatory and legal environment. Therefore, the Committee believes that small improvements to the existing standard-setting process and the process of issuing interpretive implementation guidance in the U.S. may significantly influence behaviors and help financial reporting to better serve the needs of investors and other users.

Also, many aspects of the proposals and approaches are already in place or occur informally in practice, but some of these existing processes may not be fully effective or well-understood. Therefore, the proposals and approaches are meant to both increase the effectiveness of these processes, as well as their transparency, which will be critical if the behavior of participants in the financial reporting process is to be influenced. However, the interdependence of the Committee’s proposals and approaches will necessitate many, if not all, of them being implemented if the perceived benefits are to be fully realized.

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III. Increased User/Investor Involvement

As discussed more fully below, the Committee has developed the following proposal relating to increased user/investor involvement in the standard-setting and regulatory processes:

Developed Proposal 3.1: Additional user/investor involvement in the standard-setting process is central to improving financial reporting. Only if user/investor perspectives are properly considered will the output of the financial reporting process meet the needs of those for which it is primarily intended to serve. The SEC should formally encourage the following improvements:

- ***Additional users/investors should be added to the FAF to ensure that additional views of users/investors are brought to bear in the governance process.***
- ***Experienced users/investors who regularly use financial statements to make investment decisions should be better represented on both the FASB Board and its staff to ensure that the standard-setting process and the process of issuing interpretive implementation guidance better consider the usefulness of the resulting information.***
- ***As more fully described in developed proposal 3.4, consideration of user/investor views in the agenda-setting process should be increased as part of a formal Agenda Advisory Group.***
- ***The FASB should solicit comments from a diverse panel of experienced users/investors on whether the proposed changes improve the current approach prior to exposing new accounting standards or interpretive implementation guidance for public comment.***
- ***The FASB should consider other measures designed to ensure that the user/investor perspective is given preeminence when balancing the perspectives of constituents during the standard-setting process.***

Background: User/investor involvement is critical to maintaining effective financial reporting, yet the intricacy of certain accounting matters and the overly complex nature of the current debate often make it difficult to attract meaningful user/investor participation in the standard-setting process. The Committee believes that it is important to reiterate the preeminence of the user/investor perspective in the design and implementation of financial reporting. By properly emphasizing the perspective of users/investors, all stakeholders will benefit from a system that allocates capital more efficiently. This perspective can be best promoted by taking a number of basic steps in improving user representation throughout the standard-setting process.

The Committee acknowledges the significant effort by the FASB over the past few years to increase user/investor involvement in standard-setting. Specifically, the FASB has leveraged a number of existing advisory groups and has established a number of

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additional advisory groups to assist with bringing additional user/investor perspectives, including:

- The Financial Accounting Standards Advisory Council (FASAC), which has more than 30 members, including several users of financial information.
- In 2003, the FASB established the User Advisory Council (UAC), which includes representatives from individual and institutional investors, equity and debt analysts, lenders and credit rating agencies.
- In 2005, the FASB established the Investor Task Force (ITC), which is comprised of representatives of many of the nation's largest institutional asset managers.
- In 2007, the FASB established the Investors Technical Advisory Committee (ITAC) to increase participation in the standard-setting process by users/investors with strong accounting backgrounds.
- The FASB also creates resource groups to assist either formally or informally on major projects, which often includes some user/investor representation.
- The EITF includes two user/investor representatives.

Because users/investors often lack a monolithic viewpoint and have differing perspectives, the FASB may receive mixed messages with respect to a particular issue. Therefore, developed proposal 3.1 is intended to provide the SEC and FASB with more focused, efficient, and timely user/investor feedback.

FAF and FASB: Increasing the direct involvement of users/investors on the FAF and FASB could have a significant benefit of bringing these perspectives to the forefront of the accounting standard-setting process and the process of issuing interpretive implementation guidance. Therefore, the Committee recommends that the composition of the FAF Trustees include more user/investor perspectives and that the FASB Board include no less than one, but perhaps more, users/investors who regularly use third party financial statements.

The proposal complements the FAF's proposed changes to the size and composition of the FAF and the FASB in its recent *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB*. The Committee is supportive of the FAF's proposed changes, but believes that the composition of the FASB Board should be clarified to require (1) a preparer, an auditor, and at least one user/investor who regularly uses third party financial statements, and (2) that the remaining at-large Board members should be selected based upon the most qualified individuals that have a breadth of experiences to ensure that the perspectives of users/investors are represented. The Committee recognizes that a potential move towards five FASB Board members from seven would increase the influence of users/investors on the Board, and believes that such a result is fully consistent with a desire to continue to build and maintain a robust system of financial reporting.

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Some participants in the financial reporting community believe that a focus on user/investor needs could be enhanced in the standard-setting process without the need to actually increase user/investor involvement on the FAF and FASB. However, the Committee concluded, on balance, that increased direct, active user/investor involvement would (1) improve the transparency of and familiarity with the standard-setting process within the user/investor community, and (2) better align the traditionally distinct fields of accounting and finance over time. Additional representation on both the FAF and the FASB will not only bring additional user/investor perspectives from those individual representatives, but also from the users/investors they choose to consult.

There may be opportunities to increase user/investor involvement on the FASB staff, as well. The FASB has a few individuals on staff whose principal professional experience is in the investing community, and the FASB has had a fellowship program in place for many years, but the auditor and preparer communities most frequently provide resources to fill these roles. The FASB has approached user/investor groups about the possibility of sponsoring fellows, but thus far has had limited success. The Committee believes that users/investors should work together to identify and advance qualified resources to join the FASB staff in fellowship positions to help improve the balance of user/investor perspectives during standard-setting.

User/Investor Fatal-Flaw Review: To further increase the direct feedback from users/investors during the standard-setting process, the FASB should add a requirement to perform a scalable user/investor fatal-flaw review designed to assess perceived benefits to users/investors prior to the issuance of Exposure Drafts. The following attributes should be considered by the FASB when designing such a fatal-flaw review:

- Seek formal comments from a diverse panel of users/investors (e.g., buy-side analysts, sell-side analysts, rating agencies), all of which should have strong interests in the outcome.
- The goal should be to ask users/investors to consider the accounting guidance through the eyes of the typical, informed investor to determine whether the new information provided would be decision useful (whether it will provide better information than what is currently available), as well as meet the benefit portion of the cost-benefit constraint.
- Perform the user/investor fatal flaw review prior to exposing the accounting guidance for public comment so the results may be factored into the cost-benefit analysis.
- The Board should be willing to revisit or even discontinue a standard-setting project based upon the feedback received.

Many aspects of the proposed user/investor fatal-flaw review may already occur on an informal basis, but the Committee notes that the benefits of such user/investor fatal-flaw reviews would best be achieved if other users/investors who may not be asked to participate in the process are at least aware of their existence. Therefore, the Committee

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proposes that the process be formalized, required for all new standards, and made more transparent.

Such a fatal flaw review would be analogous to obtaining experienced user/investor input that the reporting regime would improve as a result of the implementation of the proposed standard. The Committee does not envision that this requirement would supplant any of the other important, systematic user/investor feedback that the FASB receives throughout the standard-setting process.

Other FASB Measures: The FASB does have comments in its mission statement, precepts, and objectives that speak to importance of users of financial information, and its precepts provide for balancing perspectives. However, the Committee believes that the FASB Board and staff should consider the user/investor perspective to be preeminent in their decision-making processes, given that (1) users/investors are the primary beneficiaries of financial reporting, and (2) such a focus ultimately benefits all stakeholders by making the capital markets more efficient and robust.

Although it is important to strike an appropriate balance between the perspectives of users/investors, preparers and auditors, the objective in the near-term should be to improve that balance by increasing consideration of the users/investors' perspectives in the standard-setting process. Therefore, the FASB should consider other measures, which may include clarifying the Board's mission statement, stated objectives and precepts, designed to ensure that the user/investor perspective is given preeminence when balancing the perspectives of constituents during the standard-setting process. In addition, all Board members and staff should attempt to routinely evaluate accounting standards and interpretive implementation guidance from the perspective of a typical, informed user/investor. This is not to say that other perspectives should be ignored; rather, consideration of the needs of the recipients of the financial information itself should be paramount.

Question for the Committee:

3.2) Do you agree with developed proposal 3.1? What revisions, if any, would you recommend?

IV. FAF Governance

As discussed more fully below, the Committee has developed the following proposal relating to FAF governance:

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Developed Proposal 3.2: The SEC should assist the FAF in enhancing its governance over the FASB, as follows:

- ***By formally supporting the FAF’s proposals outlined in the “Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB”, particularly the decision to end the constituent-based approach to selecting trustees.***
- ***By encouraging the FAF to amend the FASB’s mission statement, stated objectives or precepts to highlight that an additional goal should be to minimize avoidable complexity.***
- ***By encouraging the FAF to consider developing performance metrics to monitor the FASB’s compliance against its stated goals over time.***

Proposed FAF Governance Changes: The Committee is supportive of the FAF’s recent *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB*, as outlined below.

FAF Size and Composition:

- 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. The Committee is supportive of these proposals, particularly the decision to end the constituent-based approach to selecting trustees, but believes that additional representation from users/investors as further described in developed proposal 3.1 should be considered.

FAF Oversight:

- The FAF proposes to increase its active oversight of the FASB. Many of the developed proposals and conceptual approaches in this chapter provide meaningful input and support regarding how and in what areas such oversight should be strengthened.
- As noted below, the FAF should also consider establishing performance metrics to measure and track the efficiency and effectiveness of the standard-setting process over time.
- As noted in developed proposal 3.3, establishing a formal Agenda Advisory Group will help reduce influence on the Board from any single group of constituents and maintain its independence.

FASB Board Size and Composition:

- The FAF proposes to change the size and composition of the FASB. The Committee is supportive of such changes, but as noted in developed proposal 3.1, the composition of the FASB Board should be clarified to require (1) a preparer, an auditor and at least one experienced user/investor who regularly uses third party financial statements. The Committee recognizes that a potential move towards five board members from seven would increase the influence of users/investors on the Board, but believes such a result is appropriate.

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FASB Voting:

- The FAF proposes to maintain the FASB's current majority voting requirement. The Committee is supportive of this proposal to further promote the timeliness of the standard-setting process and the process of issuing interpretive implementation guidance.

Leadership of the Agenda by the FASB Chairman:

- The FAF proposes to give the FASB Chairman control over the FASB's agenda. The Committee understands that the FAF intends for the FASB Chairman to continue to consult with other Board members, the SEC and user/investor advisory groups when making agenda decisions. The proposed formal Agenda Advisory Group in developed proposal 3.3 could help serve that function. An Agenda Advisory Group, which would include more formal user/investor involvement than currently exists, would help shield the FASB from influence by any single group of constituents, while at the same time injecting transparency and accountability into the agenda-setting process for all involved parties. Given that the proposed Agenda Advisory Group would not have a binding impact on the FASB's agenda, instilling more decision-making authority in the FASB Chairman, combined with a *requirement* to consult, would be a positive step towards increasing the efficiency of the Board.
- However, the Committee would like to highlight that an essential aspect of effective management of the agenda would be to remove items based upon other priorities. This would allow the Board to be more effective in the projects it perceives as the most beneficial.

Objectives: The FASB's mission statement, objectives and precepts recognize that efficient functioning of the capital markets relies upon credible, concise, transparent and understandable financial information. They also discuss the importance of the usefulness of financial information, keeping standards current, considering areas of deficiency that need improvement, international convergence, understandability of the results, neutrality, weighing constituent views, satisfying the cost-benefit constraint, minimizing disruption by providing reasonable effective dates and transition provisions, following an open due process, and reviewing the effects of past decisions in a timely fashion to interpret, amend or replace standards, when necessary.

The Committee believes that minimizing avoidable complexity (see definition in chapter 1) should be an additional explicit goal to which the FASB aspires. Amending its mission statement, stated objectives or precepts may cause Board members and the FASB staff to give explicit and transparent consideration during the standard-setting process to whether or not there are less complex alternatives to the positions being evaluated during the standard-setting process.

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Performance Metrics: The FAF should also consider establishing performance metrics to measure and track the efficiency and effectiveness of the standard-setting process over time. The Committee does not believe that such metrics would have a detrimental impact on the Board's independence; rather, they should be designed to introduce accountability into the standard-setting process. Properly established performance metrics may also assist the FAF in balancing the competing requirements in standard-setting of timeliness and conceptual merit. The FAF might consider developing performance metrics designed to assess timeliness and compliance with stated goals in the FASB's mission statement, objectives and precepts as a starting point.

Question for the Committee:

3.3) Do you agree with developed proposal 3.2? What revisions, if any, would you recommend?

V. Standard-Setting Process Improvements

As discussed more fully below, the Committee has developed the following proposal and conceptual approach relating to improving the standard-setting process:

Developed Proposal 3.3: The SEC should formally encourage the FASB to further refine its standard-setting process by performing the following:

- ***Creating a formal Agenda Advisory Group that includes strong representation from users/investors, the SEC and the PCAOB to actively recommend priorities for managing standard-setting priorities in the U.S.***
- ***Improving its procedures for field testing, field visits and cost-benefit analyses, by:***
 - ***Requiring that scalable field tests, field visits, and cost-benefit analyses be performed for new standards that would better leverage resources in the preparer, auditor, and user/investor communities; and***
 - ***Implementing certain cost-benefit process improvements.***

Formal Agenda Advisory Group: A formal Agenda Advisory Group that includes strong representation from users/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 the agenda of the standard-setting system, while at the same time maintaining an appropriate focus on user/investor needs. The Committee acknowledges that many of the consultations that would occur formally under its proposal occur informally today at the SEC and FASB; however, the Committee believes that formalizing the process and making it more transparent would assist in managing competing priorities and increase accountability.

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The primary goals of the formal Agenda Advisory Group would be to (1) help the standard-setting process become more nimble, (2) help the standard-setter keep its authoritative guidance as useful as possible by keeping it current, and (3) reduce the need for the SEC or other parties to issue interpretive implementation guidance. By identifying emerging issues and building consensus about which group is best positioned to deal with them (e.g., the FASB, EITF or SEC) and in what form, the formal Agenda Advisory Group would give immediate input about how best to prioritize near-term versus long-term priorities.

The Committee does not believe that input currently received regarding the FASB's agenda should be lessened in any way; rather, it should be centralized, more formal and more timely. A formal Agenda Advisory Group should be implemented contemporaneously with a reconsideration by the Board of whether to consolidate some of the *input* currently received regarding its agenda from other sources that may otherwise overlap with the Agenda Advisory Group. By involving representatives from its other advisory groups in the Agenda Advisory Group, the FASB Chairman may be able to centralize user/investor perspectives, thereby increasing their prominence during the agenda setting process (see developed proposal 3.1).

The proposed formal Agenda Advisory Group would be different from the role already performed by FASAC. Timely involvement would be critical to proper functioning of the Agenda Advisory Group, and as such, it should be able to be convened on short notice, if necessary. The Agenda Advisory Group should also vote (and provide that information in an advisory capacity to the FASB Chairman, who would make the final agenda decision), thereby maintaining transparency and improving accountability. Lastly, the Agenda Advisory Group would include active involvement of the SEC in referring agenda matters in a transparent and timely manner. These are functions that FASAC does not currently perform, although representation similar to that currently enjoyed by FASAC members would be instrumental to the proper functioning of the formal Agenda Advisory Group.

In creating such a formal Agenda Advisory Group, the SEC and FASB should consider the following additional elements:

- Active user/investor involvement.
- Timeliness. The Agenda Advisory Group should be convened both on a regular schedule, as well as, as noted above, on short notice telephonically to deal with urgent matters, as necessary.
- Transparency and accountability. The Agenda Advisory Group should vote on certain aspects of the standard-setting agenda and provide that information in an advisory capacity to the FASB Chairman, who would make the final agenda decision. Part of the rationale for calling a vote would be to maintain transparency and increase accountability of the FASB Chairman to the FAF regarding the effectiveness of agenda decisions.

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- Involvement by the SEC. One or more senior representatives from the SEC Office of the Chief Accountant should be on the Agenda Advisory Group, as the SEC often identifies practice issues prior to the designated private-sector standard-setter. In addition, active involvement of the SEC will help coordinate how and by whom guidance should be issued, thereby reducing the impetus for the SEC to issue interpretive implementation guidance.
- Openness versus timeliness. The general preference for open due process should be balanced with the need for ensuring timely advice on emerging issues so that the benefit of being able to build consensus on who is best able to deal with emerging issues may be achieved.
- Involvement by the FASB Board. All FASB Board members should be invited as official observers of the Agenda Advisory Group so that they may hear the views of various constituents directly.
- Involvement by the PCAOB. A senior representative from the PCAOB should be an official observer of the Agenda Advisory Group, as actions taken by the PCAOB significantly impact behavior of participants in the U.S. financial reporting community.
- Involvement by others. Constituents otherwise not represented on the Agenda Advisory Group should be able to present agenda requests, similar to the function of the current EITF Agenda Committee.
- Framework for agenda setting. A framework similar to that currently used by the EITF Agenda Committee should be developed that may assist the formal Agenda Advisory Group with making agenda setting and prioritization decisions.

Field Visits, Field Testing and Cost-Benefit Analyses: The FASB often visits with a number of interested constituents regarding particular standards as they are being deliberated, referred to as field visits. During development of a standard, usually prior to issuance of an Exposure Draft, the FASB may choose to conduct field visits for the purpose of assessing the costs and benefits or operationality of the proposed standard. During the comment period, the FASB may also conduct field tests, during which the adoption of a proposed standard is actually tested so that issues may be identified and resolved. However, as a practical matter and in consideration of resource constraints, the setting of many recent standards has not included robust field testing.

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 is difficult to assess prior to preparers using the standard in the preparation of financial statements, auditors auditing that information, regulators regulating it, and users/investors

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assessing the benefits of the resulting accounting and disclosure. Further, cost-benefit considerations are sometimes based largely on anecdotal evidence, which does not consistently include preparers, auditors, users/investors, and regulators.

The Committee believes the FASB could improve its procedures for field testing, field visits and cost-benefit analyses. Specifically, scalable field tests, field visits and cost-benefit analyses should be a required part of the standard-setting process for all new standards. The rigor required in each of these procedures should be scaled based upon active consideration by the FASB of the length, difficulty and magnitude of impact of the accounting standard or interpretive implementation guidance, and the FASB may conclude that field visits and field tests may not be warranted for certain standards or interpretive implementation guidance.

Ideally, field visits, field testing and cost-benefit analyses would occur at the same time, as the same participants would be involved in each for a particular standard. Therefore, the FASB should continue to leverage work already being done by preparers, auditors, task forces and user/investor groups to assess the impact, operationality and auditability of proposed standards to help inform its views. Requesting assistance from preparers, auditors and users/investors either directly or through task forces and resource groups (perhaps on more of a rotational basis than is done in practice today) would bring additional subject matter expertise and recent business experience to each field visit, field test and cost-benefit analysis. Many of these processes occur today, but additional benefits may ensure if they were consistently done in a more timely, systematic, and transparent fashion as a matter of policy.

The FASB is currently considering new initiatives to improve its field testing and cost-benefit analyses. The Committee supports the FASB's efforts in this regard and as a complement to that initiative, the FASB should consider the following improvements to its existing cost-benefit procedures:

- Select preparers, auditors, users/investors and regulators to be involved based upon their interest in the standard or interpretive implementation guidance being developed.
- Improve the transparency around the amount of work that is currently done by exposing the entire analysis for public comment (rather than a summary or abstract), thereby enhancing the ability of interested constituents to comment on the conclusions reached and the basis for those conclusions.
- Refrain from discussing costs and benefits on a net basis, as this sometimes creates opacity around the data underlying such conclusions. The analyses of costs and benefits should be prepared separately, with an indication of how the Board weighed the evidence in its conclusion.
- Attempt to better quantify the costs (in addition to providing qualitative assessments). If there is concern about the accuracy or reliability of the data, frame those concerns

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in the analysis rather than omitting the data. A cost estimate and how it was arrived at should be requested from constituents who claim that costs are excessive.

- Add auxiliary information to put the accounting standard or interpretive implementation guidance into context (e.g., expectation of the impact of the standard on the number of companies, overall market capitalization metrics of constituents expected to be impacted).
- Improve the discussion of the cost-benefit conclusions in the basis for conclusions of new standards so that it may be referred to over time when re-assessing the original cost-benefit conclusions as part of the post-adoption effectiveness reviews and reviews of the overall effectiveness of U.S. GAAP, as further described in developed proposal 3.5.
- Consider leveraging economist resources to assist the FASB staff in preparing and reviewing cost-benefit analyses.

Conceptual Approach 3.A: The Committee is considering proposing that subject to the conclusions reached in the future deliberations of international considerations described above the SEC encourage a re-prioritization of the standard-setting agenda, which may include the following:

- 1. Consider the Committee's proposals and the potential prioritization of those proposals.***
- 2. Verify, issue, and implement the codification of U.S. GAAP, including a re-codification of existing SEC literature, if needed, (see developed proposal 3.4) and removal of redundancies between SEC disclosure requirements and other sources of GAAP (See chapter 2).***
- 3. Continue efforts towards international convergence (jointly with the IASB).***
- 4. Complete the conceptual framework (jointly with the IASB).***
- 5. As further described in developed proposal 3.5, add phase II of the codification project to the agenda and consider whether GAAP should be systematically revisited, as follows:***
 - To be more coherent post codification.***
 - To remove redundancies and/or conflicts with the conceptual framework.***
 - As further described in developed proposal 3.2, to be less complex, where possible.***
 - As further described in conceptual approach 3.C, to be designed optimally.***
 - To readdress frequent practice problems (as identified by restatement volumes, input from the SEC, implementation guidance issued, frequently-asked questions).***
 - To amend, replace, or remove outdated standards.***
- 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 (See chapter 2).***
- 7. Address emerging issues that urgently require attention (either directly or through a delegate).***

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Background: The Committee recognizes that the priorities of both the SEC and the FASB are very difficult to manage; both organizations face significant challenges associated with competing priorities from a number of different constituents, as well as needing to manage both near-term and long-term priorities. In particular, the FASB has been constrained by its need and desire to fulfill its obligations under the Memo of Understanding with the IASB regarding international convergence matters. While commonly acknowledged as a priority in global standard-setting, the Committee recognizes that coordinating accounting conclusions amongst different Boards and staff is challenging.

However, as part of its proposed formal Agenda Advisory Group, the Committee is deliberating a conceptual approach regarding what the priorities of both the FASB and SEC should be in the current environment. The Committee plans to finalize its proposal after completing its deliberations on international considerations later in 2008, which would be expected to significantly impact its proposal. In fact, some participants in the U.S. financial reporting community have indicated that a full-scale adoption of IFRS in the U.S. may be the most expeditious way to shorten the lengthy timeline that would be required to complete the list of priorities being deliberated by the Committee as noted above.

Most of the Committee's proposed priorities for the SEC and FASB are self-explanatory, but one merits additional explanation, as follows:

Conceptual Framework: The completion of the conceptual framework, and a reconsideration of conflicts between the revised conceptual framework and U.S. GAAP, will be an important step to improving the coherence of U.S. GAAP. Specifically, the FASB should have such a conceptual framework that it may refer back to over time when setting standards to ensure cohesiveness and consistency. Many of the issues currently being addressed by the FASB as part of the conceptual framework project are challenging and will have a pervasive impact on U.S. GAAP. The Committee is highly supportive of the FASB's efforts in this regard. Due to the potentially significant impact on U.S. GAAP of changes to the conceptual framework, it will be important that constituents agree with the direction of the FASB; to do so, there may be opportunities during Board deliberations to further clarify what the specific impacts will be of recommended changes to the conceptual framework. The FASB should be careful to highlight those changes to prevent consequences that are unintended or misunderstood by users/investors, preparers, auditors and regulators.

Question for the Committee:

3.4) Do you agree with developed proposal 3.3? What revisions, if any, would you recommend?

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Question to be Subsequently Considered by the Committee:

3.5) Do you agree with conceptual approach 3.A? What revisions, if any, would you recommend?

VI. Interpretive Implementation Guidance

As discussed more fully below, the Committee has developed the following proposal and conceptual approach regarding interpretive implementation guidance:

Developed Proposal 3.4: The number of parties both formally and informally interpreting U.S. GAAP should be reduced. The SEC should coordinate with the FASB to clarify roles and responsibilities regarding the issuance of interpretive implementation guidance, which would further reduce uncertainty in the U.S. financial reporting community. Specifically, the following steps should be taken:

- ***The first phase of the FASB's codification should be verified, issued and implemented in a timely manner.***
- ***So that the benefits of the FASB's codification efforts may be fully realized, the SEC should ensure that the literature it deems to be authoritative is able to be integrated into the FASB codification to the extent practicable, including through a re-codification of such literature if necessary.***
- ***Going forward, there should be a single private-sector standard-setter for all authoritative accounting standards and interpretive implementation guidance applicable to a particular set of accounting standards (e.g., U.S. GAAP, IFRS). For U.S. GAAP, the FASB should continue to serve this function. The SEC and the FASB should also continue to be judicious when determining when to issue interpretive implementation guidance.***
- ***In instances when the SEC identifies accounting matters that it believes may apply or should be applied broadly, the SEC should refer those items to the FASB as part of the formalization of the informal feedback loop that is currently in place.***
- ***All other sources of interpretive implementation 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 judgments applied in good faith.***

Background: Historically, interpretive implementation guidance has proliferated from a variety of sources and, intentionally or not, becomes additional sources of U.S. GAAP that may add to the complexity in the financial reporting system, especially when questions exist about its authoritative nature or conflicts exist between interpretations. Over the past few years, the FASB has taken actions intended to reduce the proliferation

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of authoritative interpretive implementation guidance from different bodies, including being recognized by the SEC as the private-sector accounting standard-setter for U.S. GAAP and limiting the ability of other bodies to create authoritative guidance without Board ratification. The SEC staff is also a source of interpretive implementation guidance, such as through comment letters, staff speeches, staff accounting bulletins and other forms of guidance that, although typically non-authoritative, are often perceived in the marketplace as quasi-authoritative.

Codification: The FASB has undertaken a significant project to develop a comprehensive, integrated codification of existing accounting literature organized by subject matter that is intended to become an easily retrievable single source of U.S. GAAP. The Committee applauds the FASB's foresight in working on such a project and recognizes the significant effort that the codification entails. The codification will (1) bring all sources of authoritative U.S. GAAP together by topic into a single, searchable database so that they may be more easily researched, (2) clarify what guidance is authoritative versus non-authoritative, and (3) put each standard into a more consistent format, to the extent possible.

Although the codification will not change the substance of U.S. GAAP, the codification should make it easier to apply U.S. GAAP by gathering in one place all the relevant authoritative literature. However, SEC literature, which has developed through different mechanisms, may not be as easily integrated into the FASB codification. The codification will similarly not deal with the root causes of the proliferation of interpretive implementation guidance, nor the behavior of participants in the U.S. financial reporting community.

Notwithstanding these concerns, the Committee is supportive of the FASB's efforts to issue, validate and implement the codified version of U.S. GAAP over the upcoming year. Completion of the FASB's codification project is an important aspect of clarifying roles and responsibilities between the SEC and the FASB by flattening the GAAP hierarchy to two levels and stating explicitly those sources that are authoritative and those that are not. With that in mind, the Committee proposes that the SEC work with the FASB to ensure that the FASB's draft codification is verified, issued and implemented in a timely manner so that its benefits may be realized as quickly as practical. To improve existing U.S. GAAP, the FASB should consider a second phase of the codification project that would systematically revisit U.S. GAAP, as further described in developed proposal 3.5. The SEC should ensure that all interpretive implementation guidance it deems to be authoritative is also codified, which may require a re-codification of the SEC literature itself so that the benefits of the FASB's codification project may be fully achieved.

Authoritative Guidance: The Committee believes that authoritative interpretive implementation guidance that is broadly applicable to a particular set of accounting

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standards (e.g., U.S. GAAP, IFRS) is best issued by a single, private-sector standard-setter such that the guidance may be immediately updated in the codified version of that set of accounting standards. For U.S. GAAP, the FASB should continue to serve this function. In addition, the SEC and the FASB should continue to be judicious when determining when to issue interpretive implementation guidance.

Feedback Loop: The SEC should formalize the mechanism by which it currently informally refers agenda topics to the FASB such that the FASB may be the sole issuer of authoritative interpretive implementation guidance that is broadly applicable, thereby reducing the need for the SEC to do so. A formal Agenda Advisory Group on which representatives from the SEC staff and FASB both sit (as further described in developed proposal 3.3) could facilitate the feedback loop during which specific registrant matters with broad applicability are formally referred from the SEC to the FASB. Such a process would also leverage post-adoption effectiveness reviews of accounting standards by the standard-setter (as further described in developed proposal 3.5) and would require the formalization of the frequent, informal communication mechanisms that were strengthened between the SEC and the FASB in recent years. Such a formal, transparent feedback loop would help identify and prioritize issues with broad applicability that require authoritative interpretive implementation guidance from the designated standard-setter directly in the codified version of U.S. GAAP.

Non-Authoritative Guidance: All other interpretive implementation guidance (e.g., industry guides, accounting firm guidance) should be considered to be non-authoritative (by virtue of the fact that it will not be included in the U.S. GAAP codification) and should therefore not have more credence than well-reasoned, documented conclusions based on other, potentially-conflicting non-authoritative interpretive implementation guidance applied using a professional judgment framework (see developed proposal 3.4). Although the FASB codification initiative will help clarify the role of authoritative versus non-authoritative interpretive implementation guidance, making meaningful improvements in financial reporting will be difficult if non-authoritative interpretive implementation guidance continues to have the perception it has today of pseudo-authority in the marketplace.

Conceptual Approach 3.B: *As a follow-up to developed proposal 3.4 to further reduce interpretive implementation guidance associated with U.S. GAAP, the Committee is considering proposing that the SEC further clarify its role vis-à-vis the designated private-sector standard-setter, as well as its internal roles and responsibilities, to mitigate the risk of its actions unintentionally driving behavior, as follows:*

- ***The SEC staff should clarify that registrant-specific matters are not authoritative forms of interpretive implementation guidance under U.S. GAAP that should be analogized to or applied more broadly than to the specific***

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registrant in question as the source for preparers to make changes to their financial statements.

- *In instances when the SEC staff identifies registrant-specific accounting matters that it believes may result in the need for interpretive implementation guidance or a clarification of an accounting standard under U.S. GAAP, the SEC staff should refer those items to the FASB as part of the proposed formal feedback loop and proposed formal Agenda Advisory Group (see developed proposals 3.3 and 3.4).*
- *The SEC staff should refrain from informally communicating interpretive implementation guidance that would result in a change in the application of U.S. GAAP.*
- *The FASB and SEC should continue to be judicious when issuing broadly-applicable interpretive implementation guidance under U.S. GAAP. However, when it is necessary for the SEC to issue such broadly-applicable interpretive implementation guidance, similar to the processes followed by the FASB such guidance should (1) be deliberated with open due process and subject to public comment to the extent practicable, (2) be clearly communicated as authoritative, and (3) be easily and immediately integrated into the re-codification of SEC literature (see developed proposal 3.4).*
- *The SEC staff should revisit internal procedures and/or take further steps necessary to improve the consistency of its views on the application of U.S. GAAP.*

SEC Due Process: The SEC (i.e., the full Commission) sometimes issues rules and interpretations that comprise part of authoritative U.S. GAAP. The Commission's rule-making activities are generally open to public participation and observation. However, other activities of the SEC and its staff do not occur with the same level of open due process.

For example, the SEC Division of Corporation Finance (Corp Fin) reviews and comments on financial reports filed by registrants that are not investment companies. Corp Fin has a process for facilitating the public availability of comment letters and registrant responses to those comment letters on the SEC's website upon completion of the review process. Corp Fin also receives letters from specific registrants requesting concurrence on various reporting and disclosure issues. Similarly, OCA and Corp Fin receive requests from specific registrants for concurrence with conclusions on specific accounting interpretive implementation guidance issues. These letters are commonly referred to in the marketplace as pre-clearance. SEC staff may also issue public statements, such as Staff Accounting Bulletins (SABs), which are approved by the Chief Accountants in both Corp Fin and OCA. In addition, SEC staff give speeches and issue letters to industry expressing views on accounting topics.

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Consistency: The Committee considered how to improve internal processes between various Offices and Divisions within the SEC to improve the consistency of accounting advice given by the SEC staff. Although the Committee understands that there are processes in place to build consensus on accounting matters within the SEC, the Committee believes there is room for improvement in this regard. The possibility of inconsistent accounting advice emanating either across and within various Offices and Divisions within the SEC creates confusion in the marketplace.

The Committee also understands that processes exist for registrants to request reconsideration of conclusions expressed in either comment letters or in pre-clearance letters within Corp Fin and/or, to the extent it relates to interpretative implementation guidance under U.S. GAAP, by OCA, when a registrant may disagree with staff guidance or believes it is receiving inconsistent advice. However, registrants may not always use these processes for a number of reasons, such as: (1) to avoid additional delay and potential impact on market opportunities, (2) to avoid the risk of opening other accounting conclusions to reconsideration, and (3) for fear of possible retribution (misguided or not). Therefore, although the SEC staff has created checks-and-balances in the form of these reconsideration processes, they may not by themselves effectively address all consistency issues.

Registrant-Specific Guidance: Preparers and auditors may misconstrue registrant-specific accounting outcomes as quasi-authoritative forms of interpretive implementation guidance. However, the outcomes are typically fact-specific and are not always intended to be applied broadly. Nevertheless, preparers and auditors may overreact by applying those outcomes to similar, yet different sets of facts and circumstances, often believing that those outcomes require restatement.

The SEC staff advised the Committee that it does not intend for registrant-specific guidance and outcomes to be applied broadly to other registrants with potentially different fact patterns. The Committee believes that interpretive implementation guidance that is applicable only to specific registrants should not be required to be applied more broadly than to the specific registrant and recommends that the staff publicly communicate this view. This clarification would help (1) prevent preparers, auditors and other regulators from overreacting to actions taken by the SEC staff, (2) facilitate the application of reasonable professional judgment, (3) reduce the need for other parties to issue interpretive implementation guidance, and (4) support the Committee's proposal to refer broadly-applicable accounting matters that require interpretive implementation guidance to the designated private sector standard-setter.

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As noted above, the SEC staff also communicates with the public in various forms about broadly-applicable interpretive implementation guidance, including SABs,¹⁰ letters to industry, staff speeches and training manuals. In addition, Corp Fin publishes and maintains interpretive implementation guidance on the SEC website. While all of these publications contain disclaimers as to their non-authoritative nature, most financial reporting participants consider those disclaimers to be boilerplate and regard such interpretive implementation guidance as quasi-authoritative.

These publications are typically viewed by the SEC staff as confirmations of existing accounting standards, rather than as supplemental interpretive implementation guidance. However, many of these publications have in the past and continue to influence market behavior because they sometimes include SEC staff views that do supplement existing U.S. GAAP. SEC staff sometimes refers registrants to these publications to support the staff's view on registrant-specific matters. As such, many argue that such documents exemplify the SEC staff effectively setting accounting standards without open due process and point to restatements following their releases as evidence of their quasi-authoritative nature in practice.

Partially in response to these concerns, the SEC staff sometimes attempts to exercise restraint by not formalizing its views, which presents a different challenge. Over time, even these informal SEC staff views become known, although not broadly disseminated. This often results in others in the financial reporting community issuing interpretive implementation guidance that broadly attempts to communicate the SEC staff's views. This was likely one of the purposes of forming the Center for Audit Quality (CAQ), which appears to serve, in part, as a mechanism for the large audit firms to communicate with a unified voice to the marketplace about their direct communications with the standard-setters and regulators.

The Committee does not intend to limit the ability of the SEC staff to carry out its regulatory responsibilities in a timely fashion. That is why the Committee has not yet proposed a specific course of action in response to the concerns raised herein. The SEC staff is reviewing its procedures in a number of these areas and expects to unveil changes during the coming months, including procedures to enhance consistency of accounting interpretations during filing reviews and increase the transparency and usefulness of the

¹⁰ The Commission authorized the use of SABs in 1975 to achieve a wider dissemination of the administrative interpretations and practices utilized by the Commission's staff in reviewing financial statements. There had been concern that smaller audit firms and issuers would be disadvantaged because there had previously been no formal dissemination of staff practices. SABs were also designed to provide a means by which new or revised interpretations and practices could be quickly and easily communicated to registrants and their advisors. As they are designed to disseminate staff administration practices on a timely basis to the broader public, SABs are not generally exposed for public comment before release.

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reconsideration processes. The Committee is fully supportive of the SEC staff's internal review process and plans to work with the SEC staff in its deliberations in the coming months.

Question for the Committee:

3.6) Do you agree with developed proposal 3.4? What revisions, if any, would you recommend?

Question to be Subsequently Considered by the Committee:

3.7) Do you agree with conceptual approach 3.B? What revisions, if any, would you recommend?

VII. Transition to and Design of New Standards

As discussed more fully below, the Committee has developed the following proposal and conceptual approach regarding the implementation and design of standards so that they promote the use of reasonable judgments:

Developed Proposal 3.5: The SEC should formally encourage an objectives-based approach to the way standards are designed and implemented, which would allow a reasonable amount of diversity in practice, as follows:

- ***By encouraging standard-setters to refine transition guidance in new standards to make clear that a reasonable amount of diversity may exist following initial adoption of standards, which may allow the SEC to regulate compliance with new standards without forcing restatements that may not be material to users/investors, so long as the basic principles in U.S. GAAP are followed, including the importance of promoting comparability amongst preparers. Such implementation and transition guidance would continue to have a stated, required implementation date, but should acknowledge that diversity in practice post-implementation will be monitored and addressed by the standard-setter in the form of post-adoption effectiveness reviews to maintain an appropriate amount of comparability.***
- ***By encouraging post-adoption effectiveness reviews of new standards to be conducted by the standard-setter within a reasonable timeframe after adoption of new standards, as determined by the standard-setter based upon the scale of the standards themselves. By identifying diversity that develops during the review period that is perceived to undermine comparability, the standard-setters should take immediate action to reduce diversity through the standard-setting process, with appropriate transition provided to avoid restatements that may not be perceived as material to users/investors.***

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- ***By encouraging the standard-setter to also revisit all of U.S. GAAP for effectiveness on a periodic basis.***

Transition Guidance: The Committee noted that one of the significant complexities of the current financial reporting and regulatory environment is that preparers, auditors and other participants are sometimes viewed as being penalized for improving their understanding and interpretations of accounting standards over time. Said differently, if a preferred interpretation of a new standard develops after the standard has been implemented, early adopters may be forced to retain less preferable accounting or restate in future periods. This issue can be especially problematic for new standards. Furthermore, the fear of having reasonable, good-faith judgments overturned, may cause preparers, auditors and regulators to engage in defensive accounting and auditing.

Therefore, standard-setters should refine implementation and transition guidance in new standards to make clear that a reasonable amount of diversity may exist following initial adoption of new standards, which may allow the SEC to regulate compliance with new standards without forcing restatements that may not be perceived as material by users/investors, so long as the basic principles in U.S. GAAP are followed, including the importance of maintaining comparability. There will be a careful trade-off; within reasonable limits, comparability will not be undermined by permitting reasonable diversity, so long as the consequences are not material to investors.

The goal of such refinements would be that the accounting standards themselves would not be written with an attempt to close every loop-hole to prevent abuse, nor answer every implementation issue in advance. Rather, with objectives-oriented standards, the financial reporting community would accept some diversity in practice in early years, and not compel restatements as experience is gained, but make as appropriate prospective changes to properly address longer-term comparability.

This may be accomplished by the FASB providing a clear post-adoption effectiveness review period (review period) for all new standards (the length of which would be determined by the standard-setter based on the scale of the standard, but typically 1-2 years), during which time preparers may benefit from authoritative or non-authoritative interpretive implementation guidance to learn about how the standard is being interpreted and implemented without being forced to restate (except in clear cases in which the registrant fails to comply with the basic principles of the standard). Such a review period may require the FASB to adopt standard transition guidance written into all new standards, and, because the SEC regulates based upon the standards themselves, may have the effect of allowing the SEC to regulate in a more flexible manner.

However, this is not meant to imply that preparers should have the flexibility to implement new standards at different times. Rather, the review period would merely clarify that a reasonable amount of diversity may in some situations exist until the

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FASB's first post-adoption effectiveness review is completed. Thereafter, the standard-setter would re-evaluate the standard and may make additional amendments.

Nor is this proposal meant to usurp the SEC's authority to regulate abusive behavior. Clear violations of U.S. GAAP or inadequate disclosure would continue to be dealt with by the SEC through enforcement and the comment review processes. However, issues arising during the review period that are purely interpretive would be re-considered by the FASB either during or at the end of the review period in a post-adoption effectiveness review and standard-setting would be completed by the FASB to clarify the standard and reduce diversity in practice, as necessary.

Post-Adoption Effectiveness Reviews: After a new accounting standard has been in place for a reasonable period of time, more data are likely to be available to evaluate its cost, efficacy, utility and/or relevance in the current environment. However, currently the FASB does not have a formalized, transparent process in place to do post-adoption effectiveness reviews of new standards in an agreed-upon timeframe or a broader effectiveness review of U.S. GAAP on a systematic basis. As such, standards may miss important matters, not properly consider implementation issues, have unintended consequences, and may lose their relevance and effectiveness over time. As a consequence, useful financial information might not be made available to the users of financial statements.

The FASB has a stated mission and precept that obligates it to perform such effectiveness reviews,¹¹ and in satisfaction of those requirements, the FASB regularly receives input from various constituents and periodically revisits some of its standards. However, the Committee believes that the process by which post-adoption effectiveness reviews are completed should be formalized in policy, be more systematic, be more transparent, involve input from a broader range of constituents, and be monitored using relevant performance metrics. The benefit of doing so would be to remove much of the uncertainty that exists in the marketplace around when, how and from whom interpretive implementation guidance will be issued. As noted earlier, the uncertainty is a direct consequence of the fear of being second-guessed and is a symptom of the tendency to engage in defensive accounting and auditing. By formalizing the process, the Committee hopes to diffuse some of those fears and change behavior of participants in the financial reporting community.

The goal of post-adoption effectiveness reviews would be to assess whether or not the accounting standard accomplished its intended purpose, or whether it had unintended consequences that need to be resolved. Specifically, as a matter of policy, the FASB

¹¹ Part of the FASB's stated mission is to "Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process" and one of the FASB's stated precepts in the conduct of its activities is "To review the effects of past decisions and interpret, amend or replace standards in a timely fashion when such action is indicated."

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should conduct formal post-adoption effectiveness reviews of new standards within 1-2 years of implementation (or earlier, based upon facts and circumstances as evaluated by the standard-setter) to do the following:

- Deal with implementation matters that arise.
- Ensure that only an acceptable amount of diversity in practice exists.
- Ensure that the accounting that is being produced is what the standard-setter intended and is useful to readers of the financial statements.
- Reassess the cost-benefit analysis, as necessary.

Reviews of the Effectiveness of U.S. GAAP: In addition, the SEC and the standard-setter should perform a similar effectiveness review of U.S. GAAP periodically to formally consider the following:

- Input from users/investors, preparers, auditors and regulators about standards that may be improved or eliminated.
- Practice problems identified by the SEC.
- Restatement activity.
- The amount of interpretive implementation guidance required since that last post-adoption effectiveness review.
- The costs and benefits of standards (or accounting models in general).
- The need to amend, replace or remove outdated standards.
- Opportunities to be more coherent post codification (see conceptual approach 3.A).
- Opportunities to reduce avoidable complexity.
- Opportunities to migrate to an optimal design of standards (see conceptual approach 3.C).

Some participants in the financial reporting community have commented that there are a small number of accounting standards that are in immediate need of re-evaluation. The Committee believes that the formalization of a process for the standard-setter to receive, evaluate, and address such input is critical to the proper functioning of the U.S. capital markets. However, making a determination on specific standards would best be left to the FASB, with oversight from the FAF and input from the formal Agenda Advisory Group that assists with agenda-setting priorities.

The Committee has considered the recent *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB* issued by the FAF and believes that FAF's proposed changes to increase its monitoring of the FASB's effectiveness complement the Committee's proposal. The FAF should closely oversee whether post-adoption effectiveness reviews and periodic reviews of the overall effectiveness of U.S. GAAP are adequately implemented to ensure that they occur in a timely fashion.

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Impact on Standard-Setting: The Committee acknowledges that many of the aspects included in its proposal for post-adoption effectiveness reviews and overall GAAP effectiveness reviews occur in practice today. The Committee is supportive of the ongoing efforts of the FASB to accomplish these reviews and recognizes that its current convergence efforts and other pressing needs make agenda prioritization difficult. Formalizing these processes, including creation of the proposed Agenda Advisory Committee, and increasingly leveraging the FAF trustees and participants in the preparer, auditor, user/investor, and regulatory communities may increase the efficiency and effectiveness of these review procedures. In addition, the FAF and FASB should consider whether other increases in staffing may be required to facilitate the proposals herein.

Conceptual Approach 3.C: As a follow-up to developed proposal 3.5, the Committee is considering proposing that the SEC formally encourage improvement in the way standards are written, as follows:

- ***By supporting accounting standards being written following an agreed-upon framework of what constitutes an optimal standard. Such standards 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.***
- ***By supporting accounting standards being written in a manner that promotes trust and confidence in efficient markets by encouraging the use of professional judgments made in good-faith. The preparers and auditors should apply the standards faithfully, and the regulators should monitor and address abusive application of the standards.***

Professional Judgment: Chapter 4 of the report discusses a proposal regarding the creation of such a professional judgment framework. The success of such a framework is a condition precedent to the developed proposals and conceptual approaches in this chapter, for the following reasons:

The Committee believes that the fear of having reasonable, good-faith judgments overturned significantly influences the behavior of participants in the U.S. financial reporting community and results in non-authoritative literature being perceived as quasi-authoritative in the marketplace. A professional judgment framework would change behaviors of participants in the financial reporting community, thereby making the standard-setting system in the U.S. more efficient. In proposing such a step, the Committee believes that such a framework will be dependent on changes in behavior from all participants in the financial reporting process, including preparers refraining from engaging in practices commonly construed as earnings management and gatekeepers, including auditors and underwriters, diligently serving their intended roles in the marketplace.

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Such changes in behavior – by preparers and auditors who should apply accounting standards faithfully and invoke the use of professional judgment only when appropriate – and by the regulatory and legal communities, who should exercise professional skepticism while respecting reasonable professional judgments made in good-faith – would rebalance the system of checks-and-balances that is critical to the efficient functioning of the U.S. capital markets. It would also enable a simplification in the design of standards and reduce the demand for further detailed interpretive implementation guidance in response to defensive accounting and auditing. This would allow the standard-setters to revisit U.S. GAAP with an eye to making its requirements easier to understand and apply. Without such changes in behavior by all parties, meaningful improvements in the standard-setting process will be difficult.

Optimal Design of Standards: Some participants in the U.S. financial reporting community believe that certain accounting standards do not clearly articulate the objectives and principles upon which they are based. The objectives and principles inherent in existing U.S. GAAP are sometimes overwhelmed by detailed rules, examples, scope exceptions, safe harbors, cliffs, thresholds and bright lines. In addition, U.S. GAAP is not typically written in plain English. This makes it difficult for preparers and auditors to apply the standards' underlying objectives and principles, which creates risk that the appropriate rule is not identified and considered, and causes uncertainty in application, because rules cannot cover all possibilities. 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 (termed earlier as defensive accounting and auditing). The result is an accounting system that is overly complex, has little room for professional judgment, and can engender a check-the-box approach.

The Committee recognizes that the question of how to design standards going forward is at the center of a decade-long principles-based (or objectives-oriented) versus rules-based accounting standards debate. Rather than engaging in such a debate, the Committee prefers to think of optimal accounting standards in terms of what characteristics they might possess. The Committee is considering various suggestions on the optimal design of standards, including the work of the CEOs of the World's Six Largest Audit Networks, who are attempting to build consensus about what optimal accounting standards might look like in the future and whether a framework should be created that the standard-setters may refer back to over time to ensure that such characteristics are optimized. The latest step in this effort was the creation of such a draft framework, which will be presented at the Global Public Policy Symposium in January 2008.

The Committee is supportive of these efforts and understands that the draft framework will likely recommend that optimal accounting standards have the following characteristics:

- Faithful presentation of economic reality,
- Responsive to users' needs for clarity and transparency,

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- Consistency with a clear Conceptual Framework,
- Based on an appropriately-defined scope that addresses a broad area of accounting,
- Written in clear, concise and plain language; and
- Allows for the use of reasonable judgment.

In addition, in his testimony before the United States Senate Subcommittee in Securities, Insurance and Investment on October 24, 2007, the Chairman of the IASB, Sir David Tweedie, noted a similar set of four characteristics, two of which augment the aforementioned six, including: (1) whether they can be explained simply in a matter of a minute or so, and (2) they make intuitive sense.

Future Considerations: The Committee also plans to further deliberate what optimal transition guidance should be in the future that would balance user/investor needs for consistent information with feasibility and cost considerations associated with recasting historical information during the retrospective adoption of new accounting standards.

Question for the Committee:

3.8) Do you agree with developed proposal 3.5? What revisions, if any, would you recommend?

Question to be Subsequently Considered by the Committee:

3.9) Do you agree with conceptual approach 3.C and future considerations? What revisions, if any, would you recommend?

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CHAPTER 4: AUDIT PROCESS AND COMPLIANCE

I. Scope

The Committee has concentrated its efforts to date primarily on the subjects of financial restatements and whether the provision of guidance with respect to the materiality of errors and how to correct errors would be beneficial. The Committee has also considered professional judgment and whether a judgment framework would enhance the quality of judgments and the willingness of others to respect judgments made.

Question for the Committee:

4.1) Do you agree with the plan in the area of audit process and compliance?

II. Financial Restatements

II.A. Background

Potential Causes of Restatements

A significant and increasing number of restatements¹² have occurred in the U.S. financial markets in recent years. Restatements generally occur because errors that are determined to be material are found in a financial statement previously provided to the public. Therefore, the increase in restatements appears to be due to an increase in the identification of errors that were determined to be material. The increase in restatements has been attributed to various causes. These include more rigorous interpretations of accounting and reporting standards by preparers, outside auditors, the SEC, and the PCAOB; the considerable amount of work done by companies to prepare for and improve internal controls in applying the provisions of section 404 of the Sarbanes-Oxley Act; and the existence of control weaknesses that companies failed to identify or remediate. Some have also asserted that the increase in restatements is the result of an overly broad application of the concept of materiality¹³ (and discussions regarding materiality in SAB

¹² For the purposes of this chapter, a restatement is the process of revising previously issued financial statements to reflect the correction of an error in those financial statements. An amendment is the process of filing a document with revised financial statements with the Commission to replace a previously filed document. A restatement could occur without an amendment, such as when prior periods are revised in a current filing with the Commission.

¹³ A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

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99, *Materiality*, (as codified in SAB Topic 1M)) (i.e., resulting in errors being deemed to be material when an investor may not consider them to be important).

It is essential that companies, auditors, and regulators strive to reduce the frequency and magnitude of errors in financial reporting. However, the goal is not to reduce the number of restatements per se. Indeed, companies should restate their financial statements to correct errors that are important to current investors. Investors need accurate and comparable data and restatement is the only means to achieve those goals when previously filed financial statements contain material errors. Efforts to improve company controls and audit quality in recent years should reduce errors, and there is evidence this is currently occurring.¹⁴ The Committee recommends that public companies focus on reducing errors in financial statements. At the same time, some of the other recommendations of this Committee, such as those that address the current complexity of financial reporting and improving the standard setting process, will also be helpful in reducing some of the frequency of errors in financial statements.

While reducing errors is the primary goal, it is also important to reduce the number of any unnecessary restatements (i.e., those that do not provide important information to investors). Unnecessary restatements can be costly for companies and auditors, reduce confidence in reporting, and create confusion that reduces the efficiency of investor analysis. This portion of this chapter describes the Committee's recommendations regarding (1) additional guidance on the concept and application regarding materiality and (2) the process for and disclosure of the correction of errors.

Committee Research

The Committee has considered several publicly-available studies on restatements.¹⁵ The Committee is aware that the Treasury Department also has recently selected University of Kansas Professor Susan Scholz to conduct an examination of the impact of and the reasons for restatements of public company financial statements. The Committee will review the Treasury Department's study and consider its findings as they are made available.

¹⁴ Glass Lewis & Co. report "Brief Alert Weekly Trend" issued December 17, 2007 shows that restatements in companies subject to Section 404 of the Sarbanes Oxley Act have declined for two consecutive years.

¹⁵ Studies considered include the U.S. Government Accountability Office (GAO) study "*Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates*" (March 2007); Glass Lewis & Co. study "*The Errors of Their Ways*" (February 2007); and two Audit Analytics studies "*2006 Financial Restatements A Six Year Comparison*" (February 2007) and "*Financial Restatements and Market Reactions*" (October 2007). The Committee has also considered findings from the PCAOB's Office of Research and Analysis's (ORA) working paper released October 18, 2007, "Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era," understanding that ORA's findings are still preliminary in nature as the study is still going through a peer review process.

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The restatement studies all indicate that the number of restatements has increased in recent years. Market reaction to restatements might be one indicator of whether or not restatements contain information considered by investors to be material. While there are limitations¹⁶ to using market reaction as a proxy for materiality, based on these studies, it would appear that there may be many restatements occurring that investors may not consider important due to a lack of a statistically significant market reaction. The Committee believes that additional guidance on determining whether an error is material and whether a restatement is necessary would be beneficial in reducing the frequency of unnecessary restatements.

The Committee has also considered input from equity and credit analysts and others about investors' views on materiality and how restatements are viewed in the marketplace. Feedback included:

- Bright lines are not really useful in making materiality judgments. Both qualitative and quantitative factors should be considered in determining if an error is material or not.
- Companies often provide the market with little financial data during the time between a restatement announcement and the final resolution of the restatement. Limited information seriously undermines the quality of investor analysis, and sometimes triggers potential loan default conditions or potential delisting of the company's stock.
- The disclosure provided on restatements is not consistently adequate to allow a user to evaluate the likelihood of errors in the future. Notably, disclosures often do not provide enough information about the nature and impact of the error, and the resulting actions the company is taking.
- Interim periods should be viewed as more than just a component of an annual financial statement for purposes of making materiality judgments.

II.B. Developed Proposals

Based on its work to date, the Committee believes that, in attempting to eliminate unnecessary restatements, it is helpful to consider two sequential questions: (1) Was the error in the financial statement material to those financial statements when originally filed? (2) How should a material error in previously issued financial statements be corrected? The Committee believes that framing the principles necessary to evaluate these questions would be helpful. The Committee also believes that in many circumstances investors could benefit from improvements in the nature and timeliness of

¹⁶ Examples of the limitations in using market reaction as a proxy for materiality include (1) the difficulty of measuring market reaction because of the length of time between when the market becomes aware of a potential restatement and the ultimate resolution of the matter, (2) the impact on the market price of factors other than the restatement, and (3) the disclosure at the time of the restatement of other information, such as an earnings release, that may have an offsetting positive market reaction.

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disclosure in the period between identifying an error and filing restated financial statements.

With this context, the Committee has developed the following proposals regarding the assessment of the materiality of errors to financial statements and the correction of financial statements for errors.

Developed Proposal 4.1: Materiality

The Commission or its staff should issue guidance¹⁷ 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 impacts the total mix of information available to a reasonable investor.***
- ***Just as qualitative factors can lead to a conclusion that a quantitatively small error is material, qualitative factors also can lead to a conclusion that a quantitatively significant error may not be material. The evaluation of errors should be on a “sliding scale.”***

The Commission should also direct its staff to conduct both education sessions internally and outreach efforts to auditors and financial statement preparers to raise awareness of these issues and to promote more consistent application of the concept of materiality.

The Committee believes that those who judge the materiality of a financial statement error should make the decision based upon the interests, and the viewpoint, of a reasonable investor and based upon how that error impacts the total mix of information available to a reasonable investor. One must “step into the shoes” of a reasonable investor when making these judgments. The Committee believes that too many materiality judgments are being made in practice without full consideration of how a reasonable investor would evaluate the error. When looking at how an error impacts the total mix of information, one must consider all of the qualitative factors that would impact the evaluation of the error. This is why bright lines or purely quantitative methods are not appropriate in determining the materiality of an error to annual financial statements. It is possible that an error that results in a misclassification on the income statement may not be deemed to be material, while an error of the same magnitude that impacts net income may be deemed material based on the effect of the error on the total mix of information available to a reasonable investor.

¹⁷ To the extent that the implementation of the Committee’s recommendations would require a change to GAAP, the Commission should work with the appropriate standard setters to revise GAAP.

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The Committee believes that, in current practice, materiality guidance such as SAB Topic 1M is interpreted as being one-directional in that qualitative considerations can make a quantitatively insignificant error material, but a quantitatively significant error is material without regard to qualitative factors. The Committee believes that qualitative factors not only can increase, but also can decrease, the importance of an error to the reasonable investor. Specifically, the Committee believes that there should be a “sliding scale” for evaluating errors. On this scale, the higher the quantitative significance of an error, the stronger the qualitative factors must be to result in a judgment that the error is not material. Conversely, the lower the quantitative significance of an error, the stronger the qualitative factors must be to result in a judgment that the error is material.

The following are examples of some of the qualitative factors that could result in a conclusion that a large error is not material. (Note that this is not an exhaustive list of factors, nor should this list be a “checklist” whereby the presence of any one of these items would make an error not material. Companies and their auditors should still look at the totality of all factors when making a materiality judgment):

- The error impacts metrics that do not drive reasonable investor conclusions or are not important to reasonable investor models.
- The error is a one time item and does not alter investors’ perceptions of key trends affecting the company.
- The error does not impact a business segment or other portion of the registrant’s business that investors regard as driving valuation or risks.
- The error relates to financial statement items whose measurement is inherently highly imprecise.

Education and outreach efforts can be instrumental in increasing the awareness of these concepts and ensuring more consistent application of materiality. Many of the issues with materiality in practice are caused by misunderstandings by preparers, auditors and regulators. Elimination of these misunderstandings would be a significant step forward to reducing unnecessary restatements.

Question for the Committee:

4.2) Do you agree with the recommendations on materiality to annual financial statements? Are there any areas you would recommend adding or removing?

Developed Proposal 4.2: Correction and Disclosure of an Error

The Commission or its staff 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.***

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- *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 may need to be disclosed and/or 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.*
- *The current disclosure about the need for a restatement, during the period when the restatement is being prepared and about the restatement itself is not consistently adequate for the needs of investors and needs to be enhanced.*

The current guidance that is detailed in SAB 108 (as codified in SAB Topic 1N) may result in the restatement of prior annual periods for immaterial errors in those periods because the cumulative effect of these prior period errors would be material to the current annual period, if the prior period errors were corrected in the current annual period. The Committee believes that prior annual period financial statements should not be restated for errors that are immaterial to the prior annual period. An alternative to the approach specified in Topic 1N could be to require that, where errors are not material to the prior annual periods in which they occurred but would be material if corrected in the current annual period, the error could be corrected in the current annual period¹⁸ with appropriate disclosure.

The Committee believes that the determination of how errors should be corrected should be based on the needs of current investors. This determination should be based on the facts and circumstances of each error. For example, an error that does not affect the annual financial statements included within a company's most recent filing with the Commission may be determined to not be relevant to current investors. For errors that do not require restatement but were material in the annual period in which they occurred, companies could be required to provide appropriate disclosure about the error and the periods impacted.

¹⁸The Committee is focused on the principle that prior periods should not be restated for errors that are not material to those periods. Correction in the current period for errors that are not material to prior periods could be accomplished through an adjustment to equity or to current period income. The Committee believes that there are merits in both approaches and that the Commission and its staff should carefully weigh both approaches before determining the actual approach to utilize.

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For material errors that are discovered within a very short time period prior to a company's next regularly scheduled reporting date, it may be appropriate in certain instances to report the restatement in the next filing, instead of amending previous filings with the Commission. This option should be further studied and, if appropriate, should be included in the guidance.

When evaluating the need to restate when an error is discovered that relates to an interim period within an annual period for which financial statements have previously been filed with the Commission, the following guidance should be utilized:

- If the error is not material to either the previously issued interim period or to the previously issued annual period, the previously issued financial statements should not be restated.
- If the prior period error is determined to only be material to the previously issued interim period, but not the previously issued annual period, then only the previously issued interim period should be restated (i.e., the annual period that is already filed should not be restated and the 10-K should not be amended).

The Committee believes that all errors, excluding clearly insignificant errors, should be corrected¹⁹ no later than in the financial statements of the annual or interim period in which the error was discovered. There should be a practicality exception for immaterial errors discovered shortly before the issuance of the financial statements, but in this case, the errors should be corrected in the next annual or interim period being reported upon.

Typically, the restatement process involves three primary reporting stages:

1. The initial notification to the Commission and investors that there is a material error and that the financial statements previously filed with the Commission can no longer be relied upon;
2. The "dark period" or the period between the initial notification to the Commission and the time restated financial statements are filed with the Commission; and
3. The filing of restated financial statements with the Commission.

The Committee believes that one of the major effects on investors related to restatements is the lack of information when companies are silent during stage 2, or the "dark period." This silence creates significant uncertainty regarding the size and nature of the effects on the company of the issues leading to the restatement. This uncertainty often results in discounts of the company's stock price. In addition, delays in filing restated financial

¹⁹ The Committee understands that sometimes there may be immaterial differences between a preparer's estimate of an amount and the independent auditor's estimate of an amount that exist when financial statements are issued. These differences might or might not be errors, and may require additional work to determine the nature and actual amount of the error. This additional work is not necessary for the preparer or the auditor to agree to release the financial statements. Due care should be taken in developing any guidance in this area to provide an exception for these legitimate differences of opinion, and to ensure that any requirement to correct all "errors" would not result in unnecessary work for preparers or auditors.

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statements may create default conditions in loan covenants; these delays may adversely affect the company's liquidity. The Committee understands that, in the current legal environment, companies are often unwilling to provide disclosure of uncertain information. However, the Committee believes that when companies are going through the restatement process, they should be encouraged to continue to provide whatever financial information they can provide accompanied by appropriate explanation of ways in which the information could be affected by the restatement if the information is believed by management to be reasonably reliable given the circumstances. Consequently, regulators should evaluate the company's disclosures during the "dark period" taking into account the difficulties of generating reasonably reliable information before a restatement is completed.

The Committee believes that the current disclosure surrounding a restatement is often not adequate to allow users to evaluate the company's operations and the likelihood that such errors could occur in the future. Specifically, the Committee believes that all companies that have a restatement should be required to disclose information related to 1) the nature of the error; 2) the impact of the error; and 3) management's response to the error, to the extent known, during all three stages of the restatement process. Some suggestions of disclosures that would be made by companies include the following:

Nature of error

- Description of the error.
- Periods affected and under review.
- Items in each of the financial statements subject to the errors and pending restatement.
- For each financial statement line item, the amount of the error or range of potential error.
- Identity of business units/locations/segments/subsidiaries affected.

Impact of error

- Updated analysis on trends affecting the business if the error impacted key trends.
- Loan covenant violations, ability to pay dividends, or other effects on liquidity or access to capital resources.
- Other areas such as loss of material customers or suppliers.

Management Response

- Nature of the control weakness that led to the restatement and corrective actions, if any, taken by the company to prevent the error from occurring in the future.
- Actions taken in response to covenant violations, loss of access to capital markets, loss of customers or other consequences of the restatement.

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Companies should update this disclosure on a periodic basis during the restatement process, particularly when quarterly or annual reports required to be filed as material changes become known, with full and complete disclosure within the filing with the Commission that includes the restated financial statements.

The Committee believes that by providing this guidance on how to correct and disclose errors in previously issued financial statements, investors will receive higher quality information (e.g., prior periods will not be restated for immaterial items and for errors that have no relevance to current investors, and more consistently good disclosure will be made during and about the restatement process) and the burdens on companies related to unnecessary restatements will be reduced.

Questions for the Committee:

- 4.3) Do you agree with the proposal regarding the consideration of current investors in determining the need to restate?
- 4.4) Do you agree with the concept that prior periods should not be restated except for material errors?
- 4.5) Do you agree with the proposal regarding additional disclosures during the restatement process and surrounding the restatement? Are the proposed disclosures sufficient? Do the proposed disclosures create too much of a burden on companies? Are additional or different disclosures needed for investors?
- 4.6) Do you agree with the concept that all errors, except clearly insignificant errors, should be corrected no later than in the financial statements of the annual or interim period in which the error was discovered?

Developed Proposal 4.3: Errors related to interim periods

Based on available restatement studies, approximately one-third of all restatements involved only interim periods. Authoritative accounting guidance on assessing materiality with respect to interim periods is currently limited to Paragraph 29 of APB Opinion No. 28, *Interim Financial Reporting*.²⁰ Differences in interpretation of this paragraph have resulted in variations in practice that have increased the complexity of financial reporting. This increased complexity impacts preparers and auditors, who struggle with determining how to evaluate the materiality of an error to an interim period,

²⁰ “In determining materiality for the purpose of reporting the cumulative effect of an accounting change or correction of an error, amounts should be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.”

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and also impacts investors, who can be confused by the inconsistency between companies in evaluating and reporting errors. The Committee believes that guidance on how to evaluate errors related to interim periods would be beneficial to preparers, auditors and investors.

The Committee has observed that a large part of the dialogue about interim materiality has focused on whether an interim period should be viewed as a discrete period or an integral part of an annual period. Consistent with the view expressed at the outset of this Section, the Committee believes that the interim materiality dialogue could be greatly simplified if that dialogue were refocused to address two sequential questions (1) What principles should be considered in determining the materiality of an error in interim period financial statements? And (2) If an error is material, what should be the acceptable methods for correcting an error in previously issued interim financial statements? The Committee believes that additional guidance on these questions, which are extensions of the basic principles outlined in developed proposals 4.1 and 4.2, respectively, would provide useful guidance in assessing and correcting interim period errors. The Committee believes while these principles will assist in developing guidance related to interim periods, the Committee believes that additional work should be done to fully develop robust guidance regarding errors identified in interim periods.

The Commission or its staff 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 4.2.

The Committee believes that the determination of whether an interim period error is material should be made based on the perspective of a reasonable investor, not whether an interim period is a discrete period, an integral part of an annual period, or some combination of both. An interim period is part of a larger mix of information available to a reasonable investor. As one example, a reasonable investor would use interim financial statements to assess the sustainability of a company's operations and cash flows. In this example, if an error in interim financial statements did not impact the sustainability of a company's operations and cash flows, the interim period error may very well not be material given the total mix of information available. Similarly, just as a large error in annual financial statements does not determine by itself whether an error is material, the size of an error in interim financial statements should also not be necessarily determinative as to whether an error in interim financial statements is material.

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The Committee believes that applying the principles set forth above would reduce restatements by providing a company the ability to correct in the current period immaterial errors in previously issued financial statements and as a practical matter obviate the need to debate whether the interim period is a discrete period, an integral part of an annual period, or some combination of both.

The Committee also notes that these principles will provide a mechanism, other than restatement, to correct through the current period a particular error that has often been at the center of the interim materiality debate - a newly discovered error that has accumulated over one or more annual or interim periods, but was not material to any of those prior periods.

Question for the Committee:

4.7) Do you agree with the proposal and principles outlined above related to evaluating materiality and correcting errors with respect to interim periods?

III. Professional Judgment

III.A. Background

Overview

Professional judgment is not new to the areas of accounting, auditing, or securities regulation – the criteria for making and evaluating professional judgment has been a topic of discussion for many years. The recent increased focus on professional judgment, however, comes from several different developments, including changes in the regulation of auditors and a focus on more “principles-based” standards – for example, FASB standards on Fair Value and IASB standards. While both auditors and issuers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by auditors and regulators in evaluating judgments does not provide an environment where such judgments may be generally respected. This in turn can lead to repeated calls for more rules, so that the standards can be comfortably implemented.

Many regulators also appear to encourage a system in which professionals can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction. Regulators assert that they do respect judgments, but may also express concerns that some companies and auditors may attempt to inappropriately defend certain errors as "reasonable judgments." Identifying standard processes for making professional judgments and criteria for evaluating those judgments, after the fact, may provide an

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environment that promotes the use of judgment and encourages consistent evaluation practices among regulators.

Goals of a Framework

The following are several issues that a potential framework may help address:

- a. Lack of confidence by investors in the use of judgment – A professional judgment framework may provide investors with greater comfort that there is an acceptable rigor that companies follow in exercising reasonable professional judgment.
- b. Concern by preparers and auditors regarding whether reasonable judgments are respected – In the current environment, preparers and auditors may be afraid to exercise judgment for fear of having their judgments overruled, after the fact, by auditors, regulators and legal claimants.
- c. Lack of agreement in principle on the criteria for evaluating judgments – The criteria for evaluating reasonable judgment, including the appropriate role of hindsight in the evaluation, may not be clearly defined and thus may lead to increased uncertainty.
- d. Concern over increased use of “principles-based” standards – Companies, auditors and investors may be less comfortable in their ability to implement more “principles-based” standards if there is a concern over how reasonable judgments are reached and how they will be assessed.

Categories of Judgments that are Made in Preparing Financial Statements

There are many categories of accounting and auditing judgments that are made in preparing financial statements, and a framework should encompass all of these categories if practicable. Some of the categories of accounting judgments are as follows:

1. Selection of accounting standard

In many cases, the selection of the appropriate GAAP is not a highly complex judgment (e.g., you would account for a lease using lease accounting standards, pensions using pension accounting standards, etc.). However, there are cases when the selection of the appropriate accounting standard can be highly complex.

For example, the standards on accounting for derivatives contain a definition of a derivative and provide scope exceptions that limit the applicability of the standard to certain types of derivatives. To evaluate how to account for a contract that has at least some characteristics of a derivative, one would first have to determine if the contract met the definition of a derivative in the accounting standard and then

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determine if the contract would meet any of the scope exceptions that limited the applicability of the standard. Depending on the nature and terms of the contract, this could be a complex judgment to make, and one in which experienced accounting professionals can have legitimate differing, yet acceptable, opinions.

2. Implementation of an accounting standard

After the correct accounting principle is identified, there are judgments to be made during the implementation of the standard.

Examples of implementation judgments include determining if a hedge is effective or not, determining if you have an operating or capital lease, and determining what inputs and methodology should be utilized in a fair value calculation. Implementation judgments can be assisted by implementation guidance issued by standard setters, regulators or other bodies; however, this guidance could increase the complexity of selecting the correct accounting standard, as demonstrated by the guidance issued on accounting for derivatives.

Many accounting standards use wording such as “substantially all” or “generally.” The use of such qualifying language can increase the amount of judgment required to implement an accounting standard. In addition, some standards may have potentially conflicting statements.

3. Lack of applicable accounting standards

There are some transactions that may not readily fit into a particular accounting standard. Dealing with these “gray” areas of GAAP is typically highly complex and requires a great deal of judgment and accounting expertise. In particular, many of these judgments use analogies from existing standards that require a careful consideration of the facts and circumstances involved in the judgment.

4. Financial Statement Presentation

The appropriate method to present, classify and disclose the accounting for a transaction in a financial statement can be highly subjective and can require a great deal of judgment.

5. Estimating the actual amount to record

Even when there is little debate as to which accounting standard to apply to a transaction, there can be significant judgments that need to be made in estimating the actual amount to record.

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For example, there are typically not significant differences of opinions on the appropriate standard to account for loan losses or to measure impairments of assets. However, the assumptions and methodology used by management to actually determine the allowance for loan losses or determine an impairment of an asset can be a highly judgmental area.

6. Evaluating the sufficiency of evidence

Not only must one make a judgment about how to account for a transaction, the sufficiency of the evidence used to support the conclusion must be evaluated. In practice, this is typically one of the most subjective and difficult judgments to make.

Examples would include determining if there is sufficient evidence to estimate sales returns or to support the collectability of a loan.

Levels of Judgment

There are many levels of judgment that occur related to accounting and auditing. Preparers must make initial judgments about uncertain accounting issues; the preparer's judgment may then be evaluated or challenged by auditors, investors, regulators, legal claimants and even others, such as the media. Similarly, planning and performing an audit requires numerous judgments: these judgments are also potentially subject to evaluation and challenge by investors, regulators, legal claimants and others, especially when, in hindsight, it has become clear that the auditor failed to detect material errors in the financial statements. Therefore, in developing a potential framework, differences in role and perspective between those who make a judgment and those who evaluate a judgment should be carefully considered. A framework should not make those who evaluate a judgment (auditors, regulators, or others) re-perform the judgment according to the framework. Instead, a framework should provide guidance to those who would evaluate a judgment on factors to consider while making that evaluation.

Hindsight

One appropriate tool used in auditing is hindsight – the ability of the auditor to use facts that are available through the completion of the audit work to evaluate the sufficiency of management's estimates and assumptions based on actual facts that become available after those estimates are made.

For example, auditors will frequently test the accuracy of the company's accounts payable balance at period-end by looking at cash disbursement made after the period-end. This evidence allows the auditor to determine whether the accrual for unpaid expenses at year-end is adequate.

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However, the use of hindsight to evaluate judgment where the relevant facts were not available at the time of the initial release of the financial statements (including interim financial statements) is not appropriate. Determining at what point the relevant facts were known to management or the auditor, *or should have been known*,²¹ can be difficult, particularly for regulators who are often evaluating these circumstances after substantial time has passed. Therefore, the use of hindsight should only be used based upon the facts reasonably available at the time the annual or interim financial statements were issued.

Form of Framework

Some have recommended that a “safe harbor” be developed that protects the exercise of judgment in accordance with a specified framework. That approach would seem to provide greater support to auditors and preparers. However, it is unclear to the Committee whether a legal or regulatory safe harbor (i.e., an effective legal or regulatory defense based on conformity with the framework) can be adopted by the Commission or whether it would require changes in existing statutes. The Committee encourages the Commission and its staff to resolve this issue.

Another approach is for the Commission and the PCAOB to issue policy statements that describe a framework for the exercise of professional judgment and states that auditors, the Commission or the PCAOB, as applicable, would take into account the implementation of the framework in evaluating a judgment made by a registrant or an auditor. The Commission has utilized similar frameworks in the past with success. Examples of previous frameworks by the Commission include the “Seaboard” report (October 23, 2001) on the relationship of cooperation by a company to taking action in an enforcement case and the Commission’s framework for assessing the appropriateness of corporate penalties (January 4, 2006).

While not an automatic defense of the registrant’s or auditor’s judgment, a framework would provide more support to registrants and auditors that the applicable regulator would be likely to accept a judgment made if the registrant or the auditor had fully implemented the framework. The policy statement or safe harbor might also enhance the quality of judgments by providing a rigorous structure for how judgments should be made, which would also provide protection to investors as to the quality of financial statements.

The Nature and Limitations of Generally Accepted Accounting Principles:

Some have suggested that the standard in a potential judgment framework for the selection and implementation of GAAP contain a requirement to reflect the economic

²¹ The Committee believes that those making a judgment should be expected to exercise due care in gathering all of the relevant facts prior to making the judgment.

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substance of a transaction or be a standard of selecting the "high road" in accounting for a transaction. The Committee agrees that qualitative standards for GAAP such as these would be desirable and we encourage regulators and standard setters to move financial reporting in this direction. However, such standards are not always present in financial reporting today and we could not recommend the adoption of such standards in a professional judgment framework without anticipating a fundamental long-term revision of GAAP- a change that would be beyond our purview and one that would not be doable in the near or intermediate term.

For example, there is general agreement that accounting should follow the substance and not just the form of a transaction or event. Many believe that this fundamental principle should be extended to require that all GAAP judgments should reflect economic substance. However, reasonable people disagree on what economic substance actually is, and many would conclude that significant parts of current GAAP do not require and do not purport to measure economic substance (e.g., accounting for leases, pensions, certain financial instruments and internally developed intangible assets are often cited as examples of items reported in accordance with GAAP that would not meet many reasonable definitions of economic substance).

Similarly, some would like financial reporting to be based on the "high road"- a requirement to use the most preferable principle in all instances. Unfortunately, today a preparer is free to select from a variety of acceptable methods allowed by GAAP (e.g., costing inventory, measuring depreciation, and electing to apply hedge accounting are just some of the many varied methods allowed by GAAP) without any qualitative standard required in the selection process; in fact, a preferable method is required to be followed only when a change in accounting principle is made, a less preferable alternative is fully acceptable absent such a change.

The Committee believes that adopting a requirement for economic substance or for taking the "high road" would require a revolutionary change not achievable in the foreseeable future and probably not worthy of serious attention until a principles-based approach to GAAP is uniformly applied and "rules" no longer govern GAAP; our suggested judgment framework can and we believe will enhance adherence to GAAP but cannot be expected to correct inherent weaknesses in the standards to which it is applied.

III.B. Developed Proposals

The Committee has developed the following proposals:

Developed Proposal 4.4: The Commission should issue a policy statement or adopt a safe harbor on a professional judgment framework consistent with the concepts outlined below. The Commission should also encourage the PCAOB to consider similar action. Careful consideration should be made in implementing any

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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 would be applicable to accounting related judgments, including the choice and application of accounting principles, as well as the estimates and evaluation of evidence related to the application of an accounting principle. The Committee believes that a framework that is consistent with the principles outlined in this framework to cover judgments made by auditors based on the application of PCAOB auditing standards is very important and would be beneficial to preparers, investors and auditors. Therefore, the Committee recommends that the PCAOB develop a professional judgment framework for the application of and evaluations of judgments made based upon PCAOB auditing standards.

Framework for Professional Judgment in Accounting

The Concept of Professional Judgment

Professional judgment, with respect to accounting matters, should be the outcome of a process in which a person or persons with the appropriate level of knowledge, experience, and objectivity forms an opinion based on the relevant facts and circumstances within the context provided by applicable accounting standards. Professional judgments could differ between knowledgeable, experienced, and objective persons. Such differences between reasonable professional judgments do not, in themselves, suggest that one judgment is wrong and the other is correct. Therefore, those who evaluate judgments should evaluate the reasonableness of the judgment, and should not base their evaluation on whether the judgment is different from the opinion that would have been reached by the evaluator.

This framework would serve as the primary, though not exclusive, approach to evaluating the process of making professional judgments. While regulators would strongly support the principles of this framework, the mere completion of the process outlined in the framework in making a judgment would not prevent an auditor and/or regulator from asking appropriate questions about the judgment or asking companies to correct unreasonable judgments. A judgment framework would not eliminate debate, nor should it attempt to do so. Rather, it organizes analysis and focuses preparers and others on areas to be addressed thereby improving the quality of the judgment and likelihood that auditors and regulators will accept the judgment. Conversely, not following the framework would not imply that the judgment is unreasonable.

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This framework also acknowledges that generally accepted accounting principles do not always reflect the economic substance of a transaction and that it may be difficult to determine how the accounting would meet the needs of investors. Therefore, this framework would be applicable to accounting matters only to the extent that judgments were required in the choice or application of accounting principles, in estimating the amount to record, or in evaluating the sufficiency of the evidence.

In applying the components of the framework, it would be expected that the amount of documentation, disclosure, input from professional experts and level of effort in making a professional judgment would vary based on the complexity, nature (routine vs. non-routine) and materiality of a transaction or issue requiring judgment.

Components of a Framework

Critical and Good Faith Thought Process – Professional judgment should be based on a critical and reasoned evaluation made in good faith, prior to the exercise of the judgment, of an identified issue, including the nature and scope of the issue based on:

- a) Analysis of the transaction, including the substance and business purpose of the transaction;
- b) The facts reasonably available at the time that the financial statements are issued;
- c) A thorough review and analysis of relevant literature, including the relevant principles;
- d) Alternative views or estimates, including pros and cons for reasonable alternatives;
- e) Rationale for the choice selected, including reasons for alternative or estimate selected and linkage of rationale to investor's information needs and the judgments of competent external parties;
- f) Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated;
- g) Diversity in practice regarding the alternatives or estimates;²²
- h) Consistency of application of alternatives or estimates to similar transactions; and
- i) The appropriateness and reliability of the assumptions and data used.

The critical thought process should include input from personnel with an appropriate level of professional expertise and should include a sufficient amount of time and effort to properly consider the judgment.

Material issues or transactions that were analyzed pursuant to the application of the framework should be disclosed in accordance with existing disclosure requirements. This disclosure should be sufficiently transparent to inform the user of the financial statements about the substance of the transaction, including the relevant rights, obligations, risks and rewards, the relevant accounting principles, and the key

²² If there is not diversity in practice, it would be significantly harder to select a different alternative.

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assumptions that went into the judgment. When evaluating professional judgment, auditors, and/or regulators should take into account the disclosure relevant to the judgment.

Documentation – The alternatives considered and the conclusions reached should be documented contemporaneously. The lack of contemporaneous documentation may not mean that a judgment was incorrect, but would make it more difficult to support an assertion as to the nature and propriety of a judgment made at the time of the release of the financial statements.

Questions for the Committee:

- 4.8) Do you agree with the developed proposal that a professional judgment framework could be useful or should the focus be more on providing guidance on the use of professional judgment? What changes, if any, would you suggest?
- 4.9) Do you agree that the form of the framework should be a policy statement, with a “safe harbor” only being explored depending upon experience with the policy statement and the need for such a safe harbor in order to enhance the use of principles-based accounting standards?
- 4.10) Do you agree with the proposed framework? Do you have any comments regarding the proposed applicability or components of the framework?
- 4.11) Does the framework sufficiently cover all types of judgments (e.g., not only choice and application of accounting principles, but making estimates and the appropriate way to evaluate the evidence used to make the judgment)? Are there types of judgments for which the framework would not work? What modifications would be appropriate?
- 4.12) Should disclosure be required as a separate component of the framework rather than simply be considered depending upon whether disclosure is otherwise required by the Commission or GAAP? Are there other components that may be needed?

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CHAPTER 5: DELIVERING FINANCIAL INFORMATION

I. Scope

The Committee has been evaluating the information needs of investors, methods by which financial information is provided to investors, and means to improve delivery of financial information to all market constituencies. In evaluating the information needs of investors, the Committee has recognized that the information needs of different types of investors are not always the same. The Committee has agreed that information delivery must be provided in a manner that will make it efficient, reliable, and cost-effective for each of the relevant investor groups and will not significantly increase burdens on reporting companies.

The Committee has determined to focus its efforts on financial information provided by reporting companies in their periodic and current reports under the Securities Exchange Act of 1934 (“Exchange Act”) and other ongoing disclosures provided by reporting companies to investors and the market.²³ The Committee believes that it can provide some useful recommendations to enhance ongoing reporting that will enable investors to better understand reporting companies.

Based on the above, the Committee has analyzed a number of ways to improve the delivery of financial information to investors and the market. These are:

- Tagging of financial information (XBRL)
- Improved corporate website use

The Committee also intends to look at the following in the future:

- Use of executive summaries as an integral part of Exchange Act periodic reports
- Disclosures of key performance indicators and other metrics to enhance business reporting
- Improved quarterly press release disclosures and timing
- Continued need for improvements in management discussion and analysis (MD&A) and other public company financial disclosures

In furtherance of its work, the Committee has considered the views of various constituents in the financial reporting process regarding the use of XBRL. The Committee also has evaluated other information disclosure models, including those

²³ The Committee has determined not to address information delivery in registered offerings under the Securities Act of 1933 for two primary reasons. First, the SEC already has addressed information delivery in registered securities offerings when it adopted new communication rules in 2005 for registered offerings by issuers other than registered investment companies. Second, the Committee viewed information delivery relating to ongoing company reporting by public companies as the area needing greater focus.

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involving enhanced uses of technology and corporate websites. The Committee intends to continue to evaluate the use of summaries as a component of periodic reports and ways in which financial disclosures by reporting companies can be improved.

Question for the Committee:

5.1) Do you agree with the preliminary scope in the context of information delivery?
What areas, if any, would you recommend adding or removing?

II. Tagging of Financial Information (XBRL)

II.A. Background

Description of XBRL

The Committee has been examining the use of XBRL by public reporting companies because the SEC is moving rapidly in this area. In particular, the Committee has been examining the use of XBRL under the Exchange Act reporting regime.

XBRL is an international information format standard designed to help investors and analysts find, understand, and compare financial and non-financial information by making this information machine-readable. It also offers benefits to companies by allowing them to better control how their financial or non-financial information is disseminated and, by integrating their operating data with their financial reporting disclosure, to reduce reporting costs. XBRL is a computer language that permits the automation of what are now largely manual steps for access, validation, analysis and reporting of disclosure. Because XBRL uses standardized XML (eXtensible Markup Language) technology, it can be read by a wide range of diverse software systems.

Under current technology, for example, if an investor or analyst wants to compare the sales of all the pharmaceutical companies, he must download the financial statements of these companies and input the sales data into a spreadsheet. With XBRL, however, widely available software applications will be able to take the information companies submit to the SEC's EDGAR system, extract the sales numbers and download them directly to a spreadsheet. This process will take seconds rather than the hours or days that might be required using current methods.

XBRL does this through standardized definitions of terms, like a dictionary. For example, there might be several terms for the top line on an income statement, which might be called sales, turnover or revenues. All of these terms mean the same thing, and are translated in XBRL into a common symbol, readable by a computer. When

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reproduced as a financial statement from the XBRL source, the statement will look exactly like the statement that the company produced for reading by humans.

The standardized terms are then arranged in a logical structure called a taxonomy. Under sales, for example, there might be several subcategories, such as sales through retailers, sales over the Internet, etc. These would be similarly standardized and included under sales (or turnover or revenues) because they are all aggregated to produce the number for sales. That logical structure is a taxonomy. A GAAP financial statement itself, in that its underlying details are summarized in the line items of a balance sheet or income statement, is a kind of taxonomy. There are taxonomies for different kinds of businesses. For example, the banking industry sector taxonomy differs from that of a software industry sector company.

XBRL also contains standardized relationships, such as EBITDA, so that if an investor or analyst wants to know the EBITDA of each of the pharmaceutical companies he would simply query the SEC's EDGAR system with the appropriate search application. The numbers would again be able to be downloaded in seconds. There would be no need to download the complete financial statements, ferret out the constituents of EBITDA and do the necessary calculations. The standardized XBRL concept of EBITDA embedded in XBRL provides all the explicit rules that enable a search engine to find the specifically identified concepts necessary to compute the number.

Status of XBRL Tagged Financial Statements in SEC Reports

The SEC has adopted a voluntary pilot program for use of XBRL in which participants submit voluntarily supplemental tagged financial information using the XBRL format as exhibits to specified EDGAR filings.²⁴ Voluntary pilot participants may use existing standard XBRL taxonomies. Over four dozen companies are participating in the pilot program and have agreed to voluntarily submit their annual, quarterly and other reports with interactive data for a period of one year. The SEC recently has expanded the voluntary filing program to include mutual funds which will file using a risk and return taxonomy developed by the Investment Company Institute.

On December 5, 2007, XBRL-US published the draft of U.S. GAAP taxonomies and draft preparer's guide for public testing and comment. The U.S. GAAP taxonomy includes tags for a company's financial statements and notes. Public review currently is scheduled to end April 5, 2008 and XBRL-US has stated that it is anticipated that the final taxonomy and preparer guidance will be issued in Spring 2008. After the final

²⁴ The SEC's voluntary XBRL rules specify the form, content, and format of XBRL submissions, description of XBRL data, timing of XBRL submissions, and use of taxonomies. For example, the rules require the tagged data to be described either as "unaudited" or, for quarterly financial statements, "unreviewed."

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taxonomy and preparer guidance is issued, the SEC EDGAR system must be modified to permit submissions tagged using such U.S. GAAP taxonomies.

The SEC has stated that it will use the initial financial statements prepared using the new U.S. GAAP taxonomy to help it further update its EDGAR system so that it will be able to “seamlessly accept and render the filings.” The Committee understands that currently, the SEC’s EDGAR system does not yet accept and render financial statements with XBRL tags based on the newly developed U.S. GAAP taxonomy.

In addition, the Committee understands that the software industry has been engaged in developing tagging and rendering (turning the XBRL tagged information into a human readable format) software for XBRL tagged financial statements. Companies generally use two methods to tag their financial statements using XBRL. The first method, called a “bolt-on” approach, involves developing the XBRL reports after the filed financial statements are developed – a process known as “mapping”. Companies also may use XBRL to tag their financial statements as part of an integrated approach to financial reporting. In an integrated approach, companies incorporate XBRL into their internal company financial systems. This integrated approach allows financial reports to be created from the XBRL tagged financial systems, without such financial statements first being prepared in “human readable format.” XBRL tagging using a “bolt-on” approach may involve somewhat more effort than using an integrated approach. Currently, there is software that allows companies to XBRL tag their financial statements using the “bolt-on” approach. Using the “bolt-on” method, companies can prepare their financial statements (including notes) in a number of formats, such as Adobe (pdf), Word, and HTML. At this time it is unknown how many companies have begun integrating XBRL tagging into their internal financial reporting systems and, therefore, it is not clear when a significant number of companies would move from a “bolt-on” to an integrated approach to XBRL tagging.

Time and Costs Involved in XBRL Tagging

The Committee understands that while the U.S. GAAP taxonomy has a significant number of individual tags or elements, it contains all of the terms or concepts commonly used in financial statements prepared in accordance with U.S. GAAP. The Committee understands that reporting companies would use only a limited number of tags or elements. For example, one large voluntary filer uses approximately 192 tags (it tags its notes as blocks rather than at a granular level) to tag its Form 10-Q. The Committee understands a related issue deals with the need for customized “extensions” if the U.S. GAAP taxonomy does not include a tag for the particular item in the company’s financial statements. Because the U.S. GAAP taxonomies currently out for public comment track U.S. GAAP, the Committee believes that there likely will be less need for customized extension elements. One of the purposes of the comment period is to identify additional tags or elements that should be added to the taxonomy, reducing the need for customized

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extensions. The draft preparer guidance also out for public comment should be evaluated by preparers, users, and others to determine if it provides adequate guidance for determining when an extension should be used by preparers.

Preparers participating in the SEC's voluntary program have indicated that the initial number of hours it took to tag the face of their financial statements under existing standard taxonomies (not the new U.S. GAAP taxonomies) using a "bolt-on" approach ranged from 80-100 hours and that the number of hours dropped significantly for subsequent reports (due to the lack of a need to replicate the tagging process for most items).²⁵ For preparers also tagging the notes to their financial statements using a "block" tag, the number of hours increased slightly. The costs to tag the face of the financial statements using standardized software were not significant. Additional time and cost was spent by at least one preparer to validate the tags that were used. In these cases, there was no auditor involvement in the process.

Thus, the type of information that is tagged also is relevant to understanding XBRL tagged financial statements. Companies have been tagging the face of their financial statements using existing taxonomies and software. As to the notes to the financial statements, additional effort may be involved. While the notes to the financial statements may easily be tagged as a block of text, unlike preparation of notes to the financial statements in a paper-based format, tagging the individual information in each note will involve additional tags and, therefore, more work than block tagging the text.

Smaller Public Company Reactions to XBRL Tagging

Smaller public company representatives recognize the benefits that XBRL would have for these companies long term, but are concerned about initial implementation costs, which development of improved tagging and verification software could help alleviate. The representatives strongly support a phased-in approach in which such smaller public companies would be included at the end, once the larger public companies had worked through any significant implementation issues, including use of company resources involved in tagging and verification of XBRL tags.

Potential Benefits of XBRL

The Committee sees the following potential benefits of XBRL for reporting companies and users of financial and non-financial information:

²⁵ For example, for one S&P 500 company participating in the voluntary pilot, 80 hours was spent learning the tagging tool, understanding SEC requirements, creating extensions for tags, and creating a process for ongoing tagging and future submissions.

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- Benefits to reporting companies
 - Improved communications with analysts and investors
 - Release of corporate data could be instantaneous and immediately usable – data can be immediately assimilated into analysts’ models; there is no need to wait for third party aggregators or staff to input the data into their own format and to transmit it to subscribers
 - Reduction in search costs both for preparers and users
 - Because of reduced search costs, there is potential for increased coverage of companies, especially mid-size and smaller companies, by sell-side and buy-side analysts, and at both major brokerage and independent research firms
 - Improved quality of data²⁶
 - Because manual input is eliminated, there will be reduced error rates in reporting and inputting of corporate data by aggregators
 - Because aggregators will not be necessary, companies will be able to maintain control over their numbers; what they report will be what goes into the models
 - Improved ability of company to tell its own story
 - Improved integration of company operating and reporting data
 - As companies become more familiar with XBRL, the Committee believes it will be to their advantage to imbed the XBRL technology in an integrated manner into their databases to drive a variety of reports, of which the filed financial statements would be one set.
 - Operating data can be accessed in the internal enterprise applications where it is regularly stored, and thus used for financial reporting purposes without the necessity for downloading to paper or manual search
 - Same electronically accessible data can also be used for other purposes beyond those of financial statements, including tax, industrial filings, audit, benchmarking, performance reporting, internal management, and sustainability
 - Significant time and cost savings if integration is accomplished
 - The full economic benefits of XBRL for companies will most likely come when they incorporate XBRL in their internal reporting, instead of using it as a “bolt-on” after a company’s financial reports are prepared.

²⁶ Although XBRL is frequently called Interactive Data, the use of the term “data” should not be deemed to imply numerical data alone. XBRL also is useful for the tagging of narrative information.

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- Benefits to users, including both retail investors and the “model builder/research analyst.”
 - Development of more easily accessed, reliable sources of relevant information – lowered cost of search will increase quantity and quality of analysis
 - Reduces the cost of inputting data into analytical frameworks
 - By eliminating manual input, reduces the likelihood of input error either by the user or the aggregator
 - Reduces user dependence on proprietary and inconsistent data sources
 - Increases the likelihood that more users will utilize the primary sources of data
 - Reduces the cost to compare companies and improves comparability
 - Potential to reduce analysts time and cost of coverage, and allow analysts to cover more companies
 - Potentially increases coverage, especially of small companies that now have no or limited coverage because of the costs of analysts’ time
 - Reduces time spent finding and keying data into analytical models
 - Reduces cost of re-distributing data provided by third-party data providers
 - Research organizations will be able to utilize their higher priced talent to spend more time in analysis rather than data gathering
 - Eases accessibility of the reported information for all investors and market participants
 - Analysts will see all of a company’s reported information, not just the information assembled and reported by aggregators
 - Eliminates time lag between the company filing its reports and analyst evaluation of the reported information
 - With simple search engines, all investors will be able to readily access all the information companies report.
 - Because of sharp reductions in costs of analysis, increases the likelihood that independent analysts will begin to offer their views to retail investors
 - Improves both analysis and dissemination of analysis to clients and others
 - Reported information goes directly into analysts’ models and is immediately accessible
 - Improves the efficient use of firm intellectual property for analysis and enables more rapid and effective collaboration/communication of these concept with clients
 - More information is contained in an XBRL report, lowering the cost of access for all reported information

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The Committee recognizes, however, that notwithstanding the potential benefits, many company officers may not understand how XBRL works or the improvements it would bring to both their financial reporting and their costs of reporting. In addition, there currently is limited acceptance of XBRL due, in part, to the following:

- Companies need greater certainty that XBRL will be adopted before they will expend the necessary resources to understand it and its benefits; and
- Companies may be concerned about potential start-up costs in adopting XBRL, including purchase of software and personnel resources for data input and training.

Further, analysts and software developers are generally unaware or uninformed about XBRL.

Implementation of XBRL Tagging of Financial Statements

The Committee believes, in conformity with the views of many preparers, users and auditors, that interactive data operating on an XBRL platform will offer significant benefits to public company preparers, users of public company reports, and the financial markets generally. XBRL has the potential to provide financial and non-financial information to the market in a way that is better, faster and cheaper than the current system, enhancing the availability, accessibility, consistency, and comparability of business information, together with cost-savings that will be of great benefit to companies, analysts, and investors alike.

The Committee believes that the SEC should eventually require all public reporting companies (preparing their financial statements using U.S. GAAP) to tag the financial statements (including footnotes) they are required to file with the SEC as part of their Exchange Act reports using XBRL. The Committee believes such a mandate is necessary in order to encourage the commitment of resources toward the necessary software development for tagging, viewing and reading of the XBRL tagged information, use of XBRL tagged data by users such as analysts and investors, and company use of XBRL tagging internally. The Committee believes that full implementation of mandated XBRL tagged financial statements will require a phase-in over a period of time, as discussed below, to allow for enhanced understanding of XBRL by preparers and users, successful use of the new U.S. GAAP taxonomies, and further development of tagging and rendering software. The Committee believes that such a phase-in should be sensitive to the concerns of smaller public companies regarding mandated XBRL tagged financial statements.

The Committee believes that mandatory implementation of XBRL will involve a number of steps leading to the ultimate goal of requiring public reporting companies to tag their financial statements using XBRL.

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First, full mandatory implementation may not be possible until the following preconditions are met:

- Taxonomy development
 - Testing of taxonomies. The testing process for the new U.S. GAAP taxonomy, which is to determine that disclosures are complete and relevant in current market environment, is now underway
 - Release of the final U.S. GAAP taxonomy and preparer guide following public review and comment;
 - Successful use of U.S. GAAP taxonomy and preparer guide by voluntary filers for a period of time
 - Status: On December 5, 2007, XBRL published the draft of U.S. GAAP taxonomies and draft preparer’s guide for public testing and comment. The U.S. GAAP taxonomy includes tags for a company’s financial statements and footnotes. Public review currently is scheduled to end April 5, 2008 and it is anticipated that the final taxonomy and preparer guidance will be issued in Spring 2008.
- Ability of SEC EDGAR to “seamlessly” accept XBRL submissions using the new U.S. GAAP taxonomy and other tagged XBRL tagged data and provide an accurate rendered version of all such tagged information.
 - Status: The SEC has stated that it will use the initial financial statements prepared using the new U.S. GAAP taxonomy to help it update EDGAR so that it will be able to “seamlessly accept and render the filings.” Currently, the SEC’s EDGAR system does not accept financial statements with XBRL tags based on the newly developed U.S. GAAP taxonomy.

Second, the Committee believes that, to achieve the desired acceptance of XBRL, on an interim basis XBRL tagged financial statements should be required to be implemented on a phased-in basis 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 with the voluntary program today, a document prepared separately from the reporting company’s financial statements filed as part of their periodic Exchange Act reports that contains the following:
 - XBRL tagged face of the financial statements;²⁷ and
 - Block tagged footnotes to the financial statements;²⁸ and

²⁷ To allow this first phase, the SEC EDGAR system must permit submissions using the new U.S. GAAP taxonomies.

²⁸ The Committee understands 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.

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- 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.

The Committee believes that a phase-in would provide business, financial planners, software developers, and users the impetus to move forward in building systems based on XBRL. For example, in connection with the mandatory implementation of XBRL, the Committee is aware that, if mandated, preparers may use a “bolt-on” solution in-house or use a service provider in the early stages before moving to a broader integrated interactive data approach. This “bolt-on” approach, for many, could be used as a means to begin to climb the learning curve in a cheap, easily managed manner. In this regard, the Committee believes that companies should have the capacity to compare XBRL tagged and rendered financial statements to avoid errors and the SEC should take steps to assist in that regard. The Committee believes that the SEC should encourage or commission the development of free software to compare rendered and filed statements.

During the phase-in period, the SEC and PCAOB should seek input from companies, investors, and other market participants as to the experience of such persons in preparing and using XBRL tagged financial statements using the U.S. GAAP taxonomies, and related costs. The SEC should consider conducting or commissioning a study of the rate of errors by companies in using the appropriate XBRL tags in comparison to the financial statement items, which should be done only after filers use uniform taxonomies and preparer guidance to tag their financial statements.

In addition, as discussed under the phase-in approach described above, the XBRL tagged financial statements would still be considered furnished to and not filed with the SEC. As part of the mandatory implementation, the Committee believes that, as is the case in the voluntary program, the SEC should make clear what liability provisions the XBRL tagged financial statements would be subject to under the federal securities laws.

Third, at the end of the phase-in period described above, and as promptly as practicable after the preconditions to full implementation discussed above are met, the SEC should evaluate the results from the phase-in period to determine whether and when to move from furnishing to official filing of XBRL tagged financial statements for domestic large accelerated filers, as well as the inclusion of all other reporting companies, as part of a company’s Exchange Act periodic reports.

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II.B. Developed Proposals

The Committee would like to make recommendations that increase certainty that XBRL will be a significant part of the reporting landscape so that preparers, users, auditors, software developers and regulators make the needed investment in XBRL.

Based on the above considerations, the Committee has developed the following proposal:

Developed Proposal 5.1: The SEC should mandate the filing of XBRL-tagged financial statements within a defined time frame after certain preconditions relating to successful taxonomy testing and capacity of reporting companies to file XBRL tagged financial statements using the new U.S. GAAP taxonomy on the SEC's EDGAR system and for the EDGAR system to provide an accurate 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 with the voluntary program today, a document prepared separately from the reporting company's financial statements filed as part of their periodic Exchange Act reports that contains the following:***
 - ***XBRL tagged face of the financial statements;²⁹ and***
 - ***Block tagged footnotes to the financial statements;³⁰***
- ***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; and***
- ***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 official filing of XBRL tagged financial statements 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.***

²⁹ To allow this first phase, the SEC EDGAR system must permit submissions using the new U.S. GAAP taxonomies.

³⁰ The Committee understands 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.

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Questions for the Committee:

- 5.2) Should the SEC mandate the filing of XBRL tagged financial statements by all public reporting companies? If not, what should the SEC mandate to encourage the use of XBRL by public reporting companies?
- 5.3) If you agree that the SEC should mandate the filing of XBRL tagged financial statements, should the SEC follow the phase-in approach described above or should it instead mandate the filing of XBRL tagged financial statements as part of the official filing at the outset?
- (a) If you agree with the phase-in approach,
- (i) do you agree that the phase-in should begin with the 500 largest domestic issuers based on public float and then expand to include large accelerated filers?
- (ii) do you agree that the initial phase-in should mandate the tagging of the face of the financial statements and the notes on a “block” basis?
- 5.4) Are the preconditions described above necessary to be satisfied before the SEC should consider mandating the filing of XBRL tagged financial statements? If not, are there any preconditions that should be required to be satisfied?
- 5.5) Should the SEC commission studies or the development of software to assist preparers and users in tagging, rendering, and viewing XBRL tagged financial statements?

II.C. Assurance

An important issue related to tagging public company financial statements using XBRL involves whether assurance should be provided by a third party. The Committee understands that among the primary benefits in providing independent assurance of XBRL documents would be that financial statement users could quickly build confidence in interactive data and increase their use of such data. One primary reason for not obtaining such independent assurance of XBRL documents is the concern that the cost and time incurred to obtain such assurance may significantly outweigh the benefits to preparers and users.

As to assurance, the Committee identified that questions arise as to whether assurance should be provided to:

1. determine if a company uses the proper XBRL taxonomy and accurately tags its financial statements;
2. assess the reasonableness of any company extensions to the XBRL taxonomy;
3. determine compliance with SEC content and format requirements;

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4. perform validation checks over footings and interchecks (for example, if inventory is reported more than once throughout the document, determine if amounts reported are consistent); or
5. determine if the information in the XBRL instance document is the same as the original filed document (applicable under a “bolt-on” state).

The Committee notes that there are ways that companies, mistakenly or deliberately, can create XBRL reports in a manner that will potentially mislead users. Accordingly, some Committee members believe that independent assurance of XBRL documents prepared by management should be provided, as described in items #1 and #5 above (at a minimum), provided that such assurance does not result in a significant increase in audit costs. They noted that accounting knowledge and professional judgment would be required in providing that assurance, but they believe that providing such assurance should not be an expensive or time-consuming activity, as many steps can be automated and other steps can be quickly and cost effectively embedded within existing audit methodologies and audit procedures.

The concept of obtaining assurance on the correct tags and matching the XBRL rendered documents to the filed statements is predicated on the belief that the incremental money and human resource costs to provide the assurance will be very small. Reviewing the tags the first time will involve significant effort, but subsequent reviews can be limited to new or changed tags. Moreover, the costs and benefits of assurance reviews may differ depending on whether companies are using the “bolt-on” rather than the integrated tagging approach. Therefore, other members of the Committee believe that it is appropriate to study the assurance process during the phase-in period to assess the actual costs and benefits of assurance that might be provided on the XBRL tagged financial statements.

The type, timing, and extent of assurance, if any, on a company’s XBRL tagged financial statements and other tagged information required to be furnished with the SEC should take into account the needs of investors, companies, and other market participants and the costs to reporting companies. Until a group of reporting companies have been required to furnish to the SEC XBRL tagged financial statements and notes using the new U.S. GAAP taxonomy for a period of time that will allow investors and other market participants to evaluate the reliability of such XBRL tagged financial statements and notes, it may be premature to make concrete suggestions regarding assurance. Accordingly, the Committee’s developed proposal does not include a specific assurance proposal. During the interim phase-in period discussed above, the SEC and PCAOB should seek input from companies, investors, and other market participants as to the type, timing, and extent of desired or needed assurance, if any. This input should include the experience of such persons in preparing and using XBRL tagged financial statements using the newly developed U.S. GAAP taxonomies, and related costs. Additionally, after public companies are required to tag their financial statements using XBRL, whether in

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accordance with the Committee's proposals or otherwise, the SEC should consider initiating a voluntary pilot program in which companies obtain assurance on their XBRL tagged financial statements (whether using a "bolt-on" or integrated approach) in order to evaluate fully potential costs and benefits associated with such effort.

Questions for the Committee:

- 5.6) Do you agree that the SEC should implement a voluntary pilot program for companies to obtain assurance on their XBRL tagged financial statements to assess the costs and benefits of assurance?
- 5.7) Should the SEC mandate that companies receive assurance during the phase-in? If yes, what type of assurance should be provided? Should auditors be required to provide that assurance or may another third party be able to provide the assurance? If no, should there be another mechanism by which users can verify that the correct XBRL tags were chosen and that the XBRL tagged financial statements are the same as the underlying financial statements? Should management be required to provide a written certification that the company chose the correct XBRL tags for its financial statements, and, during a "bolt-on" state, the information furnished to the SEC agrees with the financial statements originally filed with the SEC?

III. Improved Corporate Website Use

Background

The Committee has been examining the integral role that technology and corporate websites play in informing the markets and investors about important corporate information and developments, including website disclosure presentations that are under development by software vendors. A valuable element of such website presentations is that they often present the most important general information about the company on the opening page, with embedded links that enable the reader to drill down to more detail by clicking on the links. In this way, viewers--if they wish--can follow a path into the details of the financial statements, the company's strategy and products, its management and corporate governance, and many other areas in which investors and others may have an interest.

Improving the use of corporate websites can enable shareholders and investors to gather the level of information about a company that they believe is satisfactory for their purposes, without requiring them to wade through large amounts of written material that may provide a level of detail beyond the needs of the particular shareholder or investor.

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Corporate websites provide reporting companies a cost-effective, efficient method to provide information to investors and the market. Encouraging reporting companies to increase their use of their websites, including developing a tiered approach to deliver such corporate information on their websites, would benefit investors of all types, retail and institutional. Enhanced corporate website usage could decrease the complexity of information presentation and would enhance its accessibility. In addition, through coordination by industry participants, uniform best practices on uses of corporate websites could be developed.

The SEC has issued a series of interpretive releases and rules addressing the use of electronic media to deliver or transmit information under the federal securities laws. The SEC issued its last comprehensive interpretive release on the use of electronic media, including corporate websites in 2000. Since 2000, significant technological advances have increased both the market's demand for more timely corporate disclosure and the ability of investors to capture, process, and disseminate this information. Recognizing this, the SEC has adopted a large number of rules that mandate, permit, or require disclosure of the use of corporate websites to provide important corporate information and developments.

The Committee has heard, however, that there are continuing concerns about the treatment of website disclosures under the federal securities laws that some have argued may be impeding greater use of corporate websites. These concerns include liability for information presented in a summary format, the treatment of hyperlinked information from within or outside a company's website, and the need for clarification of the public availability of information disclosed on a reporting company website. Consequently, the Committee believes that the SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information. The Committee believes that this SEC guidance would encourage further creative use of corporate websites by reporting companies to provide information, including website disclosure formats following industry developed best practice guidelines.

Developed Proposal

Based on the above, the Committee has developed the following proposal:

Developed Proposal 5.2: The SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information addressing such issues as liability for information presented in a summary format, treatment of hyperlinked information from within or outside a company's website, and clarification of the public availability of information disclosed on a reporting company website.

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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.

Questions for the Committee:

- 5.8) Does the Committee agree with the proposal that the SEC should issue an updated, comprehensive interpretive release regarding the use of corporate websites? Should the interpretation be limited or expanded in any manner?
- 5.9) Does the Committee agree that an industry developed set of uniform best practices is the right approach in encouraging greater use of corporate websites to inform investors and the market? If not, what alternatives can be proposed that would have such effect?

IV. Use of Executive Summaries in Exchange Act Periodic Reports

Background

The Committee has been exploring a requirement to include an executive summary in reporting company annual and quarterly Exchange Act reports (Forms 10-K and 10-Q). The Committee understands that a summary report prepared on a stand-alone basis would not necessarily provide investors information they need in a desired format. However, a summary included in the forepart of an Exchange Act periodic report may provide investors with an important roadmap to the company's disclosures located in the body of such report. The executive summary in the Exchange Act periodic report would provide summary information, in plain English, in a narrative and perhaps tabular format of the most important information about a reporting company's business, financial condition, and operations. As with MD&A, the executive summary would use a layered approach that would present information in a manner that emphasizes the most important information about the reporting company and include cross-references to the location of the fuller discussion in the annual report.

The goal of the executive summary would be to help investors fundamentally understand the companies' businesses and activities through a relatively short, plain English presentation. An executive summary in a periodic report may be most useful if it included high-level summaries across a broad range of key components of the annual or quarterly report, rather than detailed discussion of a limited number of variables. The executive summary approach may be an efficient way to provide all investors, including retail, a concise overview of a company, its business, and its financial condition. For the more sophisticated investor, an executive summary may be helpful in presenting the

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company's unique story which the sophisticated investor could consider as it engages in a more detailed analysis of the company, its business and financial condition.

One alternative for such an executive summary in a periodic report would be that the summary should no more than 2 pages in length and should include the following:

1. Brief description of the company's business, sales and marketing;
2. Summary of a company's current financial statements;
3. A digest of the company's GAAP and non-GAAP key performance indicators (KPI's);
4. Summary of key aspects of company performance;
5. Summary of business outlook; and
6. References to more detailed information contained in the document, with page numbers.

The executive summary would be required to be included in the forepart of a reporting company's annual or quarterly report filed with the SEC or, if a reporting company files its annual report on an integrated basis (the glossy annual report is provided as a wraparound to the filed annual report), the executive summary instead could be included in the forepart of the glossy annual report. If the executive summary was included in the glossy annual report, it would not be considered filed with the SEC.

Future Considerations

The Committee will continue to evaluate the concept of requiring an executive summary in a public company's Exchange Act periodic reports such as the annual report on Form 10-K and quarterly report on Form 10-Q.

Questions to be Subsequently Considered by the Committee:

- 5.10) Do you believe the use of an executive summary as an integral part of a company's Exchange Act periodic report would contribute to an investor's ability to evaluate a company's disclosures?
- 5.11) Do you believe that an executive summary in an Exchange Act periodic report should be mandated or voluntary?

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V. Disclosures of Key Performance Indicators and Other Metrics to Enhance Business Reporting

Background

Enhanced business reporting and key performance indicators (KPIs) are disclosures about a company's business that is the source of its values. The Enhanced Business Reporting Consortium,³¹ has stated that the value drivers for a business “can be measured numerically through key performance indicators or may be qualitative factors such as business opportunities, risks, strategies and plans—all of which permit assessment of the quality, sustainability and variability of its cash flows and earnings.” KPIs are supplemental non-GAAP financial reporting disclosures that proponents have stated can improve disclosures by public companies. Key performance indicators are leading indicators of financial results and intangible assets that are not encompassed on a company's balance sheet. Proponents of the use of KPI's note that they are important because they inform judgments about a company's future cash flows – and form the basis for a company's stock price. It has been stated that managers and company boards of directors use KPIs to monitor performance of companies and of management. Market participants and the SEC have identified KPIs as important supplements to GAAP-defined financial measures.

Future Considerations

The important issues for the Committee to examine are what types of KPIs should be made available, in what format, at what time, and whether they are clearly and consistently defined over time. Currently, companies are disclosing some company-specific KPIs in their periodic reports filed with the SEC or in other public statements. Other people in the market are working on developing industry-specific KPIs in order to improve comparability of companies on an industry basis. The Committee will examine, among other matters, whether KPIs should be a voluntary or mandatory disclosure, who should develop the disclosure standards for defining and measuring KPIs to assure consistency among companies and through time, and whether XBRL should be extended by industry sector to include KPIs and information on intangible assets. The Committee also will examine ways in which consistent KPIs can be developed through industry coordination.

³¹ The Enhanced Business Reporting Consortium was founded by the AICPA, Grant Thornton LLP, Microsoft Corporation, and PricewaterhouseCoopers in 2005 upon the recommendation of the AICPA Special Committee on Enhanced Business Reporting. The EBRC is an independent, market-driven non-profit collaboration focused on improving the quality, integrity and transparency of information used for decision-making in a cost effective, time efficient manner.

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Question to be Subsequently Considered by the Committee:

5.12) Do you agree that the Committee should evaluate the increased use of key performance indicators and other metrics to enhance business reporting?

VI. Improved Quarterly Press Release Disclosures and Timing

Background

The quarterly press release, being the first corporate communication about the result of the quarter just ended, is viewed as an important corporate communication. It is perceived that this communication receives more attention than the formal 10 Q submission which often occurs a week or two later.

Future Considerations

The Committee intends to review the press release for its consistency, understandability and its timeliness. The Committee will consider the consistent provision of income statement, balance sheet and cash flow tables in the quarterly release. It also intends to consider the positioning and prominence of GAAP and non-GAAP figures, GAAP reconciliation, the consistent placement of topics, and clear communication of any changes to accounting methods or key assumptions. Ultimately, the Committee views the goal as a consistent, reliable communication form that all users can easily navigate.

In addition, based on anecdotal evidence and a survey of CFA Institute members, and consideration of comments received by the SEC when this idea was put forth in prior SEC rule proposals, the Committee will evaluate the advisability of the quarterly press release being put forth on the same day as the Form 10-Q is submitted, as opposed to the current lagged structure. The Committee will consider, among other things, (i) the savings in time spent cross-referencing two separate but fairly identical reports separated by a very short period and (2) the elimination of the concern that the two reports may not perfectly match.

The Committee does not intend to discuss the potential desire to do away with reporting quarterly results. Even though there is considerable concern that current financial reporting has a built in short term bias, eliminating quarterly reporting would likely lead investors to believe that they were being denied important guidepost information. The Committee elsewhere will focus on attempts to move corporate reporting in the direction of more fundamental and sustainable business measures which are often interpreted as having a longer term focus.

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Questions to be Subsequently Considered by the Committee:

- 5.13) Do you agree that the Committee should evaluate the content and timing of quarterly press releases issued by reporting companies?
- 5.14) Should the Committee evaluate other areas relating to quarterly press release disclosures?

VII. Continued Need for Improvements in MD&A and Other Public Company Financial Disclosures

Background

Every public company is required to include a MD&A section in their annual and quarterly reports filed with the SEC. The three principal objectives of MD&A are to:

- to provide a narrative explanation of a company’s financial statements that enables investors to see the company through the eyes of management;
- to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
- to provide information about the quality of, and potential variability of, a company’s earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance.

The SEC has made clear that the quality of MD&A in public company periodic reports is not as good as it should be. In 2003, the SEC concluded, based in part on the Fortune 500 report issued by the Division of Corporation Finance, that additional guidance was useful in the following areas:

- the overall presentation of MD&A;
- the focus and content of MD&A (including materiality, analysis, key performance measures and known material trends and uncertainties);
- disclosure regarding liquidity and capital resources; and
- disclosure regarding critical accounting estimates.

The SEC has stated that MD&A should not be a recitation of financial statements in narrative form or a series of technical responses to MD&A requirements.

Future Considerations

The Committee understands that investors and other market participants believe that while there has been some improvement in MD&A disclosures since publication of the SEC’s interpretive release in 2003, significant improvement is still needed both in terms of additional disclosures and elimination of what the SEC termed “unnecessary detail or duplicative or uninformative disclosure that obscures material information.”

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Under the Sarbanes-Oxley Act of 2002, the SEC is generally required to review every public company at least every three years. In that regard, the Committee believes that through the review process, the SEC will gain important insight on whether there has been improvement in company MD&A disclosures and the types of ongoing concerns regarding such disclosures. The Committee will be evaluating whether the SEC should periodically issue a report on common types of comments issued on MD&A and other financial disclosures similar to the Fortune 500 report to provide additional guidance on improving MD&A in accordance with the SEC's most recent interpretive guidance.³²

Questions to be Subsequently Considered by the Committee:

- 5.15) Should the Committee encourage the SEC to periodically issue reports on common disclosure comments issued on MD&A and other financial disclosures?
- 5.16) Are there other steps the Committee would suggest be taken to improve the quality of MD&A disclosures?

³² The Committee notes that the SEC's comment letters on a reporting company's filings are made publicly available on the SEC website after completion of the SEC's review of such filings.

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APPENDICES

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- A – Committee Members, Official Observers, and Staff
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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

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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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2. Alternative Accounting Policies

Examples of alternative accounting policies are as follows:

- SFAS No. 87, *Employer's Accounting for Pensions* and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, which permits alternatives for amortizing delayed recognition amounts and for measuring return on plan assets.
- SFAS No. 95, *Statement of Cash Flows*, which permits alternative presentations of the form and content of the statement.
- SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (specifically Q&A 35 of the SFAS 115 Implementation Guide), which indicates that companies are not precluded from classifying securities as trading, even if they have no intention of selling them in the near term.
- SFAS No. 130, *Reporting Comprehensive Income*, permits a choice in presenting comprehensive income. An entity may present other comprehensive income below the total for net income in a single statement, in a separate statement that begins with net income, or in a statement of changes in equity.
- SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which permits, but does not require, the use of hedge accounting, which, in certain circumstances, may mitigate earnings volatility from marking derivative instruments to market.
- SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits, but does not require, the measurement of certain financial assets and financial liabilities at fair value.
- EITF 88-1, *Determination of Vested Benefit Obligation for a Defined Benefit Plan*, which permits vested benefit obligations to be determined as the actuarial present value of the vested benefits to which the employee is entitled if the employee separates immediately or the actuarial present value of the vested benefits to which the employee is currently entitled but based on the employee's expected date of separation or retirement.
- EITF 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)*, which permits that certain taxes, such as sales, use, and value added taxes, to be presented either on a gross or net basis.
- EITF Topic D-98, *Classification and Measurement of Redeemable Securities*, which permits a choice of methods of accreting to the redemption value.

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- FIN 48, *Accounting for Uncertainty in Income Taxes*, which permits an entity to classify interest and penalties as either interest or taxes.
- FSP AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, which prohibits the accrue in advance method, but allows for continued use of one of three other alternatives: direct expense, built-in overhaul, or deferral methods.
- Oil & gas accounting: The two accounting methods followed by oil and gas producers are the successful efforts method and the full cost method. Successful efforts accounting essentially provides for capitalizing only those costs directly related to proved properties;³³ the costs associated with exploratory dry holes are expensed as incurred. Full cost accounting generally provides for capitalizing (within a cost center) all costs incurred in exploring for, acquiring, and developing oil and gas reserves-regardless of whether or not the results of specific costs are successful.
- SAB Topic 5H, *Accounting for Sales of Stock by a Subsidiary*, which permits gains/losses on sales of stock by a subsidiary to be recognized in income or equity.

³³ The estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economics and operating conditions.

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3. Bright Lines

Examples of bright lines, rules of thumb, and pass/fail models include the following:

A. Bright Lines

- *Lease Accounting*

Current lease accounting is based on a principle: when a lease transfers substantially all of the benefits and risks of ownership of the property, it should be accounted for as an asset and a corresponding liability by the lessee and the asset is derecognized by the lessor (capital lease); otherwise, rental expense is recognized as amounts become payable (operating lease). However, to apply this principle, SFAS No. 13, *Accounting for Leases*, provides the following bright lines for classifying leases as capital or operating. Meeting any one of these criteria results in capital lease treatment.

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
- The present value at the beginning of the lease term of the minimum lease payments, excluding certain items, equals or exceeds 90 percent of the excess of the fair value of the leased property.

- *Consolidation*

For those entities that are not subject to the FIN 46R model, consolidation is required by the party that holds the majority of the voting interests, in effect, creating a bright line of 50%. Further, there is a presumption that an investment of 20% - 50% requires equity method accounting. In addition, the equity method is required for investments in limited partnerships unless the interest “is so minor that the limited partner may have virtually no influence over partnership operating and financial policies” (SoP 78-9, *Accounting for Investments in Real Estate Ventures*). In this case, practice has used a 3%-5% bright line to apply the “more than minor” provision. This practice has been acknowledged by the SEC staff in EITF Topic No. D-46, *Accounting for Limited Partnership Investments*.

- *Revenue Recognition*

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Bright lines may also be found in revenue recognition literature. One example is SFAS No. 66, *Accounting for Sales of Real Estate*, which provides bright lines for determining the buyer's minimum initial investment requirements for real estate sales.

- *Business Combinations*

When an SEC registrant undergoes a change in control, the company must reflect the new basis of accounting arising from its acquisition in its stand-alone financial statements (i.e., apply purchase accounting to its own stand-alone financial statements) if the company becomes substantially wholly-owned. "Substantially wholly-owned" is defined such that this push down accounting is prohibited if less than 80% of the company is acquired, permitted if 80% to 95% of the company is acquired, and required if 95% or more of the company is acquired.

In addition, SFAS No. 141, *Business Combinations*, requires that the purchase price allocation period in a business combination usually not exceed one year from the consummation date.

- *Pension and Other Post-Retirement Employment Benefit Accounting*

SFAS No. 87, *Employers' Accounting for Pensions*, and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, permit the use of smoothing mechanisms that delay the recognition of the effects of changes in actuarial assumptions and differences between actual results and actuarial assumptions. However, these standards contain a bright line as to when the delayed recognition amounts should be recognized.

- *Hedge Accounting*

SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, requires that derivative instruments be recognized at fair value, with changes in fair value recognized in income. However, in an effort to mitigate earnings volatility, SFAS No. 133 permits the use of hedge accounting when a derivative is highly effective in achieving offsetting changes in fair value or cash flows attributable to the risk being hedged. GAAP, however, does not define "highly effective." Instead, practice has defined "highly effective" as an offset ratio of 80% to 125%.

- *Classification*

Bright lines are also present in classification requirements. For example, SFAS No. 95, *Statement of Cash Flows*, clarifies the definition of "cash equivalents" by stating that "generally, only investments with original maturities of three months or less

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qualify under that definition” (paragraph 8). Despite use of the word “generally,” this bright line is often interpreted stringently.

In addition, SEC Regulation S-X includes bright lines for separate presentation of amounts that would otherwise be included in lines such as revenue, other current assets and liabilities, and other assets and liabilities.

- *Disclosure*

Bright lines also exist with respect to the determination of related parties for the purposes of disclosing related party transactions and the identification of segments for the purposes of determining which operating segments require separate presentation.

Further, SEC Regulation S-X includes a number of bright lines regarding requirements to present stand-alone acquiree financial statements, stand-alone equity method investee financial statements, and pro forma financial information, among others. These bright-lines are based on the results of certain significance tests, or calculations, defined in Regulation S-X. These significance tests compare the acquiree or investee to the registrant in the areas of assets, investments, and income.

B. Rules of Thumb

- *Consolidation Accounting*

The fall of Enron in late 2001 refocused attention on the effect of bright lines as they relate to consolidation accounting. Enron, and others, took advantage of bright lines related to the consolidation of special purpose entities (SPEs) to avoid reporting assets and liabilities, to defer reporting losses, and/or report gains. At the time, the consolidation of SPEs hinged on an analogy to guidance that required lessees to consolidate SPE lessors that lacked a substantive investment at risk from an unrelated party. “Substantive” was defined as 3%, at a minimum, with the caveat that a greater investment may be necessary in certain facts and circumstances. Despite this caveat, which would suggest the need for judgment, the presence of the 3% bright line gave rise to numerous structured transactions to achieve a specific accounting purpose.

In December 2003, the FASB issued FIN 46R, *Consolidation of Variable Interest Entities*, which superseded the 3% rule. FIN 46R requires consolidation in certain circumstances by the party that holds the majority of the risks and rewards of an entity, rather than equity ownership and voting rights. This model has led some to assert that FIN 46R is a principles-based standard. However, even FIN 46R contains a rule of thumb – a presumption that if equity investment at risk is less than

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10% of the entity's total assets, the entity is a variable interest entity subject to the FIN 46R model, with similar caveats that require additional analysis, judgment and consideration.

- *Contingencies*

SFAS No. 5, *Accounting for Contingencies*, provides an example of rules of thumb in interpretations of GAAP. SFAS No. 5 establishes recognition and disclosure requirements based on the likelihood – remote, possible, probable – that a liability has been incurred. Although GAAP does not define these terms, audit firms have developed rules of thumb for these terms.

C. Pass/fail tests

- SFAS No. 48, *Revenue Recognition When Right of Return Exists*, requires that where a right of return exists, revenue be recognized at the time of sale only if certain criteria, such as the amount of future returns can be reasonably estimated. Otherwise, revenue recognition is deferred until the right expires or the criteria are subsequently met.
- SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* – if critical terms do not match or if documentation does not comply with the rules, then companies are not eligible to apply hedge accounting.
- SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* contains requirements, all of which must be satisfied, to achieve sale accounting for a transfer of financial assets. Otherwise, the transfer is treated as a secured borrowing with a pledge of collateral.
- EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, identifies a number of criteria that must be met in order for an instrument to be classified as an equity instrument. Failure to meet any of these criteria results in classification as a liability, which is marked to market through income. The criteria do not provide for probability assessments or judgments based on the preponderance of evidence.
- SoP 97-2, *Software Revenue Recognition*, related interpretations, and audit firm guidance contain the following pass/fail tests:
 - If vendor specific objective evidence (VSOE) does not exist for all of the undelivered elements of a software sales arrangement, the recognition of all revenue from the arrangement must be deferred until sufficient evidence exists, or until all elements have been delivered, unless certain exceptions are met.

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- Extended payment terms usually result in a deferral of revenue. Specifically, when extended payment terms are present, a presumption exists that the vendor's fee is not fixed or determinable, due to the possibility that the vendor may provide a refund or concession to a customer. While there are factors to overcome this presumption, interpretive guidance sets the hurdle to overcome this presumption extremely high, generally resulting in the deferral of revenue until payment is due.

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Exhibit C

Index of Written Statements Received

Listed below are the written statements received by the Advisory Committee between its second meeting on November 2, 2007 and its third meeting on January 11, 2008 and the dates of receipt.

Jan. 11, 2008	Mark F. Wille, Chair, Accounting Principles and Auditing Standards Committee, California Society of Certified Public Accountants
Jan. 4, 2008	Pascal Desroches, Chair, Financial Reporting Committee, Institute of Management Accountants
Dec. 13, 2007	Mike Gyure and Marc Siegel, Members, Investors Technical Advisory Committee
Dec. 6, 2007	Paul A. Sharman, President and CEO, Institute of Management Accountants
Nov. 20, 2007	Sam Ranzilla, Chairman, Professional Practice Executive Committee, Center for Audit Quality