Record of Proceedings

SEC ADVISORY COMMITTEE ON
IMPROVEMENTS TO FINANCIAL REPORTING
Open Meeting

Friday, May 2, 2008
8:00 a.m.

Donald E. Stephens Conference Center
5555 North River Road
Room 41
Rosemont, Illinois

Diversified Reporting Services, Inc.
(202) 467-9200

COMMITTEE MEMBERS PRESENT:

Robert C. Pozen, Committee Chairman
Dennis R. Beresford
Susan Schmidt Bies
J. Michael Cook (successful dial in?)
Jeffrey J. Diermeier
Scott C. Evans
Linda L. Griggs
Joseph A. Grundfest
Gregory J. Jonas
Christopher Liddell
G. Edward McClammy
Edward E. Nusbaum
James H. Quigley
David H. Sidwell
Peter J. Wallison
Thomas Weatherford

COMMITTEE MEMBERS ABSENT:

William H. Mann, III

OFFICIAL OBSERVERS PRESENT:

Robert Herz
Charles Holm
Mark Olson
Kelly Ayre for Kristen Jaconi

OFFICIAL OBSERVERS ABSENT:

Phil Laskawy

SEC AND COMMITTEE STAFF PRESENT:

Conrad Hewitt, SEC Chief Accountant

James Kroeker, SEC Deputy Chief Accountant

John White, Director, Division of Corporation Finance

Shelley Parratt, SEC Deputy Director, Division of Corporation Finance

Russell Golden, FASB Senior Advisor to Committee Chairman

PANELISTS:

Linda Bergen, Citigroup

Mark Bielstein, KPMG

Kevin Conn, MFS Investments

Jeff Mahoney, Council of Institutional Investors

Ben Neuhausen, BDO Seidman

Brooke Richards, American Express

John Stewart, Financial Reporting Advisors

Lynn Turner, Copera Trustee

C O N T E N T S

P R O C E E D I N G S

MR. KROEKER: I'll go ahead and call the meeting to order. There are several people also joining us by dialing in. I wonder, Bob, if you want to have a roll call of those who are dialed in? Would you want to call out their names and see? I know Mike Cook is dialing in.

CHAIRMAN POZEN: Mike Cook, are you on with us? Is anyone? Is anyone dialed in on the line?

MR. OLSON: Mark Olson here.

MR. HOLM: Charlie Holm here.

CHAIRMAN POZEN: At the moment, I don't think anyone is dialed in.

MR. KROEKER: Yes, we'll check again in a little bit. I did want to thank --

MR. OLSON: Can anybody on that end hear me? Mark Olson.

MS. AYRE: I can hear you. This is Kelly Ayre, Department of Treasury.

MR. HOLM: Are you calling in as well? This is Charlie Holm, I'm calling in as well. I can hear Mark and Treasury but --

MS. AYRE: Yes, we hear you, sir.

MR. KROEKER: Why don't we get them attached to --

CHAIRMAN POZEN: Why don't you start while they're trying to work with that?

MR. KROEKER: Yes, we'll go ahead. I did want to thank the panelists that have taken the time out of their very busy schedules to come and provide input for both panels. There's going to be input on Subcommittee 1. Subcommittee 1 is the committee that's looking at the issue of substantive complexity, and Subcommittee 2, looking at the standards-setting process. So, thanks to all the panelists for taking, again, your very busy time to provide input to this Committee.

I also want to thank the staff at the SEC. Putting this together on the road is particularly challenging, so thank you to all the CIFiR support that the staff of the SEC have provided. And also, I wanted to mention that this is also being web cast, so people are able to participate online as well. For those who are participating online, the materials are also available for you online.

So, with that, Bob, I'll turn it over to you.

PANEL ONE

CHAIRMAN POZEN: Thank you. And I think the full Committee also extends our appreciation to the SEC staff for putting together this booklet and for arranging this meeting today. And I think it might be useful if we just began by introducing the panelists and maybe we'll start with Linda, just say your name and your affiliation so that everybody just knows who everybody else is.

MS. BERGEN: I'm Linda Bergen from Citigroup, the Corporate Accounting Policy Department. I'm head of Research and Reporting.

MR. BIELSTEIN: I'm Mark Bielstein, I'm with KPMG in our Department of Professional Practice at our National Office.

MR. CONN: Kevin Conn with MFS Investments that run our financial services fund. I spend a lot of time with the financial services managements and reading through their financial statements.

MR. MAHONEY: Jeff Mahoney, General Counsel to Council of Institutional Investors.

CHAIRMAN POZEN: Okay, thank you.

MR. NEUHAUSEN: I'm Ben Neuhausen from --

CHAIRMAN POZEN: Could everyone speak a little closer to the mic?

MR. NEUHAUSEN: I'm Ben Neuhausen from BDO Seidman. I'm the National Director of Accounting for that firm.

MS. RICHARDS: I'm Brooke Richards, Vice President of Global Accounting at American Express. And I'm representing the Institute of Management Accountants.

CHAIRMAN POZEN: Thank you.

MR. STEWART: I'm John Stewart. I'm with Financial Reporting Advisors which is a small accounting consulting firm.

CHAIRMAN POZEN: Thank you. I appreciate all of you taking your time to come out. And your mics are not as strong as these mics. I don't know whether you could make sure that we can catch every word that you say.

As John and I were talking before, the John, he spells his name right, the other Jon Stewart spells his name wrong.

Do we have the people on now who are coming in by phone? Can we take a roll call? I notice Mark Olson, are you, can you hear me?

MR. OLSON: I can hear you but I don't think you can hear me.

CHAIRMAN POZEN: Yes, we can hear you. And Mike Cook?

CONFERENCE OPERATOR: Okay. Mr. Cook, Michael is trying to get into the conference call but there isn't a port available for him. We would still need to add a port and join him to the conference. Thank you.

CHAIRMAN POZEN: It sounded like the conference operator.

MS. BERGEN: She said there wasn't a port for him to get in and there apparently aren't enough lines.

MR. OLSON: Bob, this is Mark Olson. I just had added a port.

CHAIRMAN POZEN: Well, I think we're going to proceed with Mark on the phone and we're going to leave it to the technicians here to see if they can figure out how to get the other people in. I apologize for the technical difficulties.

Just to introduce what we're going to do and give the lay of the land here, we have this booklet which you all have which is the summary of status report of each of the subcommittees. This is the follow up to our interim progress report which was issued in February. The objective here is to get public input and testimony from experts on the work of Subcommittee 1 and Subcommittee 2. Our approach will be that we will run this first session until about 10:45 to 10:50, and we will concentrate on the subjects in Subcommittee 1 which is substantive complexity, to be distinguished from the session that will run from 11:00 o'clock to 12:45 which is Subcommittee 2 and which will be on the process, the FASB process of adopting standards and the implementation guidance and other process issues.

So, I think what we're going to do is, without further ado, I'm going to turn the meeting over to Sue Bies who is head of Subcommittee 1. And we are not going to have opening statements. With a panel this large, by the time we finish with opening statements, there would be no time for questions. So, we're going to launch right into questioning and Sue is going to take the lead. Thank you.

MS. BIES: Thanks, Bob. And I'm going to sort of kick off the comments and the other three members of my committee will jump in with questions in that. First I want to just thank the SEC staff people who have been so great in supporting our committee -- We tend to have vigorous discussions when we meet and they have been very good in responding to our various inputs and things in drafting and we thank you very much for all of your help on this.

What we thought we'd do today is sort of walk by topic through the questions that we sent to the panelists ahead of time. And so, the first area we'd like to have you engage in a dialogue with us is around the whole mixed attribute model. I think we want to really focus on two big issues, and that is, how far should fair value accounting go? Since it's something that's been talked about for quite a few years, it's gotten recently more attention. And what are the issues if you go beyond trading assets and fair value?

And then, after we've had a bit of discussion in that, we'd like to then turn to the second issue which we have called in a very technical way the "chunking" issue where we're trying to deal with how do you relate the income statement and the cash flow statements, especially if you do things that are fair valued where the gains and losses aren't realized. And as a former bank regulator, this is something we care a lot about, especially in today's world where gains were booked but never realized, so it's phantom capital as far as a regulator is concerned. So, we'd like to talk about some of the things we've laid out that would sort of help us find a better way to relate all that information together in various financial statements.

So, let's start with the scope of fair value. How far should fair value go? And whoever would like to sort of kick that off then we can get the dialogue going here.

MR. STEWART: Sue, do you have in mind financial as well as non-financial assets?

MS. BIES: Yes.

MR. STEWART: And liabilities?

MS. BIES: Yes.

MR. STEWART: As opposed to just financial?

MS. BIES: Well, that's where we want some input.

MR. STEWART: Well, I'll get it started. I mean, I think what's important is two broad things. One, what the users of financial statements, what are they interested in and what would be most helpful to them. They, after all, are the consumers of what we do. I think accounting is in the business of communicating and it's a practical art to try to help communicate.

So, and then there is the issue of whether it's doable. If you can't do it, it's not very useful I would think. If the guys in Kokomo, Indiana, I'm from Indiana so I can talk about Indiana, if the guys in Kokomo can't do it, it's not going to be productive, it's not useful. So, with regard to what investors seem to need, I think that the input I read from surveys including those at CFA are mixed. The CFA institute seems to be very big on financial instruments being at fair value and maybe more than that. On the other hand, some of the other surveys, I've seen a couple from PricewaterhouseCoopers that did some good surveys of users, a recent one from Europe, indicate that they are not at all as thrilled with fair value even for financial instruments as the CFA people are.

So, I think, from what I read, and I'm not a user, I'm a doer, I'm a practitioner, so I can maybe weigh in on the second thing as to whether things are doable, but in terms of what investors need, I think it's not clear to me. My bias growing up was to be in favor of fair value. That's what I always thought made sense. On the other hand, the users don't seem as excited about it as other users do, and I'm confused, if you will, as to what they want and need. But that's the first issue.

As to the doability, I think we're finding with Statement 157 that even for financial instruments it's a challenge. And then, when you get outside of financial instruments, it's even more challenging. So, I think that there has got to be a lot of education at the colleges, of practitioners, at appraisal firms, to get us up to speed to more of it if in fact it's needed.

So, let me stop at that point and see if others want to jump in here.

MS. RICHARDS: I guess I can go next. Do I need to --

CHAIRMAN POZEN: I'm afraid our mics still are not working that well, so you'll have to really get up close.

MS. RICHARDS: Okay. Well, I believe, I'm somewhat of a proponent of fair value although I do think it should be taken slowly and in caution so that all the problems can be resolved and the preparers can do it. I'm not sure about the user view. I know that there are different types of users and maybe for some it's useful, for others maybe not just like John said.

I think where fair value is good is where there is uncertainty. For example, guarantees and contingencies. When there is uncertainty, instead of having a yes or no answer, I think it's better to incorporate that uncertainty into the measurement. And I know it's not always easy but I think it's the most representationally faithful measure of anything with uncertainty, and even uncertainty in amounts.

Stock compensation --

CHAIRMAN POZEN: I'm sorry, I didn't quite get your point. You think fair value should be used or should not be used when there is uncertainty?

MS. RICHARDS: I think it should be used.

CHAIRMAN POZEN: Okay. Can I ask you what is usually called level 3 information? How do you feel about that evaluation of, that's a very high level of uncertainty.

MS. RICHARDS: I think level 3 has been used for a long time. It's, in my experience, not always a hundred percent precise. I mean, it's never a hundred percent precise, but yet it's better than zero.

MS. BIES: Can I make sure we're talking the same terminology? If we can differentiate between risk and uncertainty? I mean, conceptually, uncertainty is a concept that by its definition you don't know what it is. You just know that there's other random factors that could affect the value of a variable, but it isn't systematic that it can be measured in a normal volatility measure or statistical model which is more of a risk. And you can have wide-ranging risk variation, 6 sigma, 12 sigma, and some statistical test.

So, there's a wide variability in terms of risk measurement, but the uncertainty is something that really cannot be defined. It's been one of the issues that I know both economists and accountants have struggled with for years. So, I want to make sure I understand, are you talking really about the uncertainty, trying to measure that, or are you talking about the volatility in measurement that are in most models including the third level models?

MS. RICHARDS: I guess I would point specifically to FAS 5 on whether you either have something on your books or nothing on your books for contingency. And instead, I believe that you should fair value that contingency and that would be a better representation of that contingency.

MR. GRUNDFEST: I just wonder if we're really talking around what the issue is, so let me try to crystallize matters and bring things to a point.

First observation, I think it's fair to say that we can all agree that the accounting system is massively, internally inconsistent in its treatment of various forms of assets and liabilities. Is that fair? Does anybody want to argue the system is consistent and coherent? Anybody?

MR. CONN: What do you mean by consistent, sir?

MR. GRUNDFEST: That if you have one piece of paper, it's valued the same way regardless of what the paper is, how it's structured and who is holding it.

MR. CONN: And you're talking about financial instruments now?

MR. GRUNDFEST: A mortgage, right? You take a mortgage --

MR. CONN: But not a plant or an intangible or good will or --

MR. GRUNDFEST: You take a mortgage, the accounting for mortgages is very different depending upon whether it's still held as a mortgage by the bank that originates it or whether it is put into some sort of credit derivative and then sliced and diced, and then you wind up holding the very highest tranche of a portfolio which is actually worth more than that one mortgage. And you can be forced to account for it at a lower price even though it's exactly the same mortgage. I mean, that's an unassailable fact.

The system is internally inconsistent, and it's internally inconsistent in a way that's very hard to rationalize other than the process and the policy and the politics of how we do our accounting. Bob? I mean, how --

MR. HERZ: I don't know if I'd, your securitization example, I'm not sure that is exactly the same. But I think just use the basic issue of securities, based on whether they're held to maturity, available for sale, or trading. And you get three different measures. You also get different measures if it's hedged or not or hedge accounting elected or not.

So, I agree with you. Any one security, that security could be held in four or five different forms of accounting.

MR. GRUNDFEST: So, you ask “What is this thing worth?" Well, then the question is why are you asking, and I can give you seven different numbers and all of them are entirely consistent with GAAP, okay? So, that's where we are. Now --

MR. STEWART: But isn't the question what is useful --

MR. GRUNDFEST: Well, right. Now, we're getting to the question of what's useful, all right.

MR. STEWART: As opposed to what's consistent.

MR. GRUNDFEST: Right. And just my first observation is that seven different numbers for the same thing doesn't strike me necessarily as being useful. All right. So, I agree with you about useful. Now let's get to useful.

In normal trading conditions, when you look at market prices, it's clear that market price is something that you need--very, very useful. Now, let's ask ourselves what's the price, okay? A price is going to reflect three different things at any point in time: the market's assessment of the cash flows that you're going to get from the instrument; the cost of trading the instrument; and also the market's perception of the financial strength of the people who are holding the instrument so that if the market perceives that there are people that are holding an instrument that may have to be selling a lot of it quickly, the market can freeze up.

The prices can go very low, nobody wants to buy something of which there's going to be a great deal for sale in the near future. And you can then wind up getting a price that reflects, for perfectly understandable reasons, an exit value that is different from what everybody would agree is the long term value of the cash flows like would be generated by that underlying instrument. I think we've actually seen that.

And now, the really interesting question going back to the issue of what's useful? What does the market need to know? It goes back to the traditional problem of central banking that Governor Bies knows real well is if you look at the traditional business of banking, it's a -- trade, all right. What you're doing is you're lending a loan. You're lending money 30 years to homeowners and what you do is you're borrowing for it, you're taking in deposits, you have six-month CDs, demand money, and if you're going to have a problem with the value of the assets, the central banker has got to figure out, is this a solvency problem or an illiquidity problem?

Well, if you were to apply FAS 157 to all of traditional central banking, everything becomes a solvency problem because you mark everything to an exit value. And you can never really have people come into a situation to solve illiquidity problem because by the definition of 157, it's never a liquidity problem; it always becomes a solvency problem. So, there's a sense in which the whole history of central banking, if you look at it carefully, is fundamentally incompatible with the implications of 157. And as Governor Bies pointed out, not only do we have problems with phantom capital in situations where mark-to-market allowed you to create capital that never really existed, we can also just by the same logic have problems with phantom losses where mark-to-market can create situations where you have to go out and raise physical capital in order to cover losses that as a practical matter were never really there. All right?

Now, ladies and gentlemen, that I think is the problem. We can talk around a whole bunch of other things, and also at the end of the day, even if we agree that these are the problems with 157, we have to do something better. Is there something better? Can 157 be improved? Can the system be rationalized? I think as we look at the financial markets, that's the challenge they're facing.

MS. BIES: Mark, you were going to make a comment a minute ago?

MR. BIELSTEIN: Yes. And maybe I'll try and tie it into those comments as well, but I think generally speaking, and following along what John said, you've obviously got to take into account what the users are really looking for and can best use them in their analysis. But generally speaking, I believe that the use of fair value in more situations for financial instruments is better than less in that the use of fair value for financial instruments reduces much more complexity in financial reporting, whether it's on the preparer side or the user side, than not. And you just think about all the things we do in financial reporting now, and I'm talking about the use of fair value with changes in fair value through earnings.

For example, we spend a lot of time trying to figure out when to move stuff from other comprehensive income and equity over to the income statement. And you know, some of those exercises are really not all that useful. And using fair value for financial instruments I think resolves many of the problems that we deal with in the complexity and practice today.

Now, obviously, you've got to make sure that's what the users need. And maybe there's different ways to address some of the issues about illiquid markets and the fair value determinations in illiquid markets as compared to 157. But generally speaking, I would think having that information is better than not having it. And some of the issues that you raised, I think, are a regulatory issue, not necessarily an accounting issue as to if the fair value is X and that creates a capital issue under the current regulatory, maybe there is a regulatory issue as to whether that's the number they ought to be using.

MR. GRUNDFEST: But Mark, here is my question. You say if the fair value is X as though you have a great deal of confidence in terms of knowing what that fair value is. In the real world, that fair value may be a wide range of numbers reflecting a wide range of forces that have nothing to do with the actual intrinsic longer term value, although it is a correct measure of the immediate exit value.

So, you're skating around all those questions by simply saying, well, we're better off with the fair market value. How do you, you've got to get into the plumbing. How do you come up with the fair market value? What does it measure? And is that the thing that we actually want?

MR. BIELSTEIN: Well, I appreciate there may be things you might want to reconsider with the 157 measurements. I think a lot of the things you can do with that is do disclosures and what the estimates are and the basis for the estimates that the company is using so that the users understand that information. But it seems to me the use of a fair value estimate for financial instruments, even in illiquid markets, is better information than cost.

MR. GRUNDFEST: I guess I'd be interested in knowing both.

MS. BIES: And that, gentlemen, let me use that as a segue into the next part of this question. One of the things the Subcommittee has been throwing around is to really look intensely at the proposals FASB is coming out with and others to really find a better way to relate the cash flow statements, especially within a fair value framework, so that however we're going to do this, we can quickly identify what's realized and unrealized. Because a mark-to-market on a loan, we know at the end of the day that no borrower is going to pay a penny more than they borrowed. So, any gain on a loan for any reason, credit, quality improvements or interest rate movements, is never going to be realized. It's just a timing difference.

And so, what we've proposed is, going back to one of the points that Joe just made, is that we've developed a framework that really rests not on an individual asset or liability but more based on the activities. And while that's difficult under 115 and we are still struggling with the definition of activity, what we want to say is that's really what we think users would like to have, and it's more relevant in the way businesses are operated that you really look at what is the earnings recognized today and what is the cash flow recognized from the different activities that go on in an organization.

But we need to somehow true up what's going on in the cash flow statements with what's going on in the income statement so that we can look across and sort of say, well, if we do use a fair value, then how much of that is realized? And how much of it is new loans extended? How much is loans paid down? How much is due to other things that affect true cash flow so that we can get the quality of what's flowing through the income statement because today we can't see it in a straight fair value or for the parts that are historic cost that we've got an ability to see on the historic cost what is that mark-to-market but lay them out in a more parallel framework based on activities.

And that's one of the proposals we've been kicking and we'd like comments. Linda?

MS. BERGEN: Yes. I fully support an activity-based accounting model. If the purpose of financial statements is to explain to the user community the company's business, then basing the accounting on the types of activities that entity conducts makes all kinds of sense to me.

For example, if a company trades their securities inventory and their commodities inventory, it makes all kinds of sense for that entity to report all of that at fair value, the best measure of fair value they can get. And if it's a trading inventory, exit value does make some sense even though there may be distortions in various markets. But for the producer of that commodity or the ultimate user of that commodity to report those same instruments at fair value doesn't make a lot of sense because they are not going to be buying and selling them in the long term. The farmer is trying to protect his profit on his crop and the user wants to contain his inventory costs. So, I think activity-based accounting is the right way to go.

In terms of extending a fair value model to loans, well, I think it depends. Whether that gain or loss on a loan is ever going to be realized depends upon where you are in that process. If that loan is going to be traded, if it's going to be sold, then that rise or decline in value will be realized in the intermediate sense. Ultimately, you're correct, what will be gained in cash flows from that loan is fixed, or at least as a maximum. So, it depends on how the entity is using that loan should determine how they value it.

To value contingent liabilities at fair value other than at the time you acquire them and through a purchase doesn't make any sense to me. I'm not sure that litigation liabilities are not traded. They're never going to be sold. Who would assume them unless you sell the entity that has that litigation outstanding. So, that kind of use of fair value I think is a misuse.

MS. BIES: Mark?

MR. GRUNDFEST: Just another quick comment about the use of fair value for financial instruments. I would also say that that is highly dependent on, I think, a financial statement presentation project that the FASB is already working on and ties in to some of your comments, Sue, that in order to continue to use fair value for financial instruments in more cases than we do now, and really even as we do now, we need better distinctions in the financial statements between what are changes in fair value as compared to the other operations. And it seems to me that the financial statement presentation project has the opportunity to do that.

MS. BIES: Anybody else who'd like to comment on the mixed attribute model in general?

MR. CONN: Susan, I have just one comment.

CHAIRMAN POZEN: You're going to have to speak a little closer.

MR. CONN: I have one comment. As a user of the statement as an investor, the migration to fair value is absolutely terrific. We're absolutely 110 percent supportive of that. Some prices in a lot of the capital markets right now are irrationally priced. So, many managements I talk to say, “Look, we're having to mark these things at 50 cents on a dollar, they're not going back to par, they're probably worth 80, we don't know. But forcing me to mark to 50 cents on a dollar is putting added pressure in our balance sheet and making us more stressed than we would be if we could apply some judgment."

And so, the level 3 bucket I find to be incredibly useful as an analyst. And I look at it before I see managements. And some of the disclosure is terrific in level 3. It's gotten a lot better.

But I would propose adding a little bit more context and texture to that because oftentimes I'll look at that disclosure, I'll ask management a question about level 3, and it's very easy to parry the questions because they're -- so, that's the only, and what would you add? You'd add things like the type of assets in level 3, how they came to value them, because there is nothing in the level 3 asset buckets that tell you what's the unobservable input.

So, a little bit more clarity around level 3, not a ton, but a half page or a page would be very helpful.

MS. BIES: Let me follow up on that. Kevin, would it be helpful if there was more of what I call "walk forward" kind of reporting? Because now you just sort of get a moment-in-time picture in the disclosures that if you learn something about what part of the change in fair value was due to actual losses taken, what was set aside for future losses, what was because of change in loans outstanding. I mean, because right now in the disclosures, there's none of that information there, yet the framework we use for historic cost are portfolio volumes, following up on Linda's point. You have that walk forwarding through the loan loss provision information.

MR. CONN: I think that kind of information would be very helpful, yes. It would help clarify some of the complexity out there.

MS. BIES: What troubles me about the use of the mixed attribute model is when you have two different accounting policies being used for the same type of activity for the same kind of instrument. For example, in your loan book where you have loans carried at amortized cost less an allowance, and you have purchased some loans, those loans are going to be reported at full fair value based on the date you acquired them, and then you'll start accumulating an allowance should you need one going forward for that. But when you look at your loan loss statistics, they're not going to be consistent because you're going to show a lower rate of loss in the purchase loans than you are in your originated loans, and it doesn't necessarily make economic sense that that's the right way to view it.

It also creates huge complexity in needing to have two separate accounting systems to record and track the various types of loans, two different ways of measuring impairment or valuation problems in those loans. That kind of inconsistency bothers me.

MR. STEWART: I said this before but I think the surveys are very insightful. And if you haven't, maybe you've seen them all, but there's one very recently for European investors that was somewhat supportive of your idea about operating and not operating, that the basis for carrying the financial asset or non-financial asset would be dependent on whether it's operating, whether it's illiquid. So, I recommend, these are people that we are serving, right, the users of the financial statements?

And therefore, I really, and they send very conflicting and inconsistent messages from survey to survey -- the CFA does surveys of the financial institutions. They are not consistent with the PWC surveys. They are not consistent with this recent European survey. And maybe someone can figure out why they're inconsistent. Maybe there is a good explanation.

Point two is the schedule that you guys are talking about that goes from a cash flow statement, from the income statement. I think that would be very difficult practically to do. Maybe it would be useful, but I think there is going to be a lot of questions of all these columns you have, distinguishing whether this is kind of a recurring kind of an adjustment or something different than that, the accrual of interest. I think it would be very difficult for preparers to do that. Maybe it would be useful but it would be hard to do in my view.

MS. BIES: Bob?

MR. HERZ: Just one point. I've seen all those surveys, too. In fact, the PWC survey, a lot of the people in there were members of what's called the Corporate Reporting Users Forum (CRUF). We met with that group in London last week as part of our meeting with the IASB. And I don't think they stated categorically that for financial instruments they want fair value. Most of the rest of the surveys, the non-fair value is more around the non-financial stuff, around intangibles and purchase accounting which they don't find particularly useful, things like that.

But there was discussion specifically on that point, and they had a bunch of them there that wanted fair value for financial instruments, which matches the much more extensive surveys that, the systematic surveys that CFA Institute had done of thousands of users here.

MR. STEWART: Well, I don't know, I'm not a user. But here, I'll read to you what a recent survey shows, not the CRUF one. "Mark-to-model fair values are regarded as significantly less decision useful than both market-based fair values and historical cost measures for practically all asset classes." So, that would include financial instruments. That's what this survey shows and I don't know what is right.

I mean, I'm a practitioner, not a user. But users ought to get to decide this, it seems to me, and drive the decision making. You know, it could be credit users like Greg or others. But I think these guys, we ought to pay attention to what they're saying, and they're not all saying the same thing.

MR. SIDWELL: Mark, you had mentioned that you think fair value for financial instruments is a good thing. I was wondering if you could give your opinion on non-financial assets and non-financial liabilities.

MR. BIELSTEIN: I would not suggest at this point expanding the use of fair value on a recurring basis for non-financial assets and liabilities. My thoughts were specifically related to financial. Now, for example, business combination accounting, we obviously need to use fair values in the initial measurements. I think one of the questions that the panel had or that the Committee had related to whether any of the provisions of Statement 141R should be delayed on contingent assets and liabilities. I think, for those, I would continue to do what those standards said and see how that goes in the implementation rather than deferring those.

MR. GRUNDFEST: Could I interrupt for just a second? And please, Mark, I beg your indulgence? It's the law professor in me that's screaming, can I go Socratic for five seconds? This is a cold call, this is the worst thing in the world.

If market value accounting is good for a financial asset, why isn't it also good for a non-financial asset for exactly the same reasons that it's good for a financial asset, whatever you happen to think those reasons are?

MR. BIELSTEIN: I actually believe that for non-financial assets where, you know, manufacturing plants and those kinds of things, that the use of fair value for those is not the same as for financial instruments.

MR. GRUNDFEST: Why?

MR. BIELSTEIN: That information may not be as useful. Now, again, that's a question for --

MR. GRUNDFEST: May not be as useful? Suppose you have a company that has no financial instruments whatsoever and the only thing it has is its manufacturing plant, it's not useful, it's essential. You can't live without it.

MR. BIELSTEIN: You can't live without?

MR. GRUNDFEST: What do you care what the historical cost is of that building? You want to know what its current market value is. It's the only asset the company has.

MR. BIELSTEIN: Well, in some part, the users are going to make those judgments based on the operations that are flowing out, that are reflected in the financial statements.

MR. GRUNDFEST: Well, then why don't we say the same about the financial instruments?

MR. BIELSTEIN: And again, this is a question for the users of the financial statements as to what's more useful to them. If I'm thinking about it from my perspective, and obviously that is not a user, but what reduces complexity in the financial statements, we have much more complexity and financial reporting in the various models we use for financial instruments than we do outside of the financial instruments.

MR. GRUNDFEST: But isn't that a good thing? Because then we can get the market value numbers that we all, and perfectly, understandably, say are more valuable for us.

MR. BIELSTEIN: Let me --

MR. NEUHAUSEN: But I think there is a difference. At least, I perceive a difference between the financial assets and the plant. Financial assets are much more liquid, they're much more easily replaced.

MR. GRUNDFEST: Oh, really? Financial are always much more liquid?

MR. NEUHAUSEN: Not always, but I think generally.

MR. GRUNDFEST: But what happens when they're not?

MR. NEUHAUSEN: And companies tend not to sell off their entire plant in single transactions. They might sell isolated plants, but for the most part they're held for operations over a long term. And I'm not convinced that today's exit value on plant is generally going to be that useful when you move over to the liability side of the balance sheet.

MS. BIES: But let me follow that thought because this is part of what gets me confused over the people who push fair value accounting. When you talk about non-financial assets, I think part of it is that we go back to this concept that accounting should reflect the earnings process of the company or its various business activities. So, you wouldn't want General Motors to recognize all the future cash flow they're going to get from a plant the day they open it, because they're going to have to run that plant and it's more important to know what's going on in that plant period to period. And so, we've got a tradition of having accounting that I think most people are comfortable with in the way the automobile plants are run day to day.

When we get to financial instruments though, we tend to not look at the activity. We tend to look at just the asset. If your trading activity, I grant the activities trading goes through earnings right away through fair value, I have no problem with that, but if you're basically someone who is borrowing funds, say your company -- you're borrowing to fund your company -- what does the mark-to-market on a periodic basis tell you about that company? Because, again, if I was wanting to lend more money to that company, I'm interested in what the cash flow is and how much debts are already incurred, I would think I have a different framework than a fair value framework which would make it much better for me as a potential debtor to value that company.

So, I think that's the issue that we're struggling with in the framework. We're going to run out of time here, so let me just, I would like to see if we can get some comment on the proposed schedule. John Stewart mentioned he thought it would be difficult. It's on page 16 of our Subcommittee report at the first section of the booklet that you got because we've been sort of looking at how we lay out these activities. And if any of you have any input on that, that would be very, very helpful to us.

MS. BERGEN: I like the example. I thought it looked good. I would want to test it at a real company probably like John said. I'm not sure where some things would go in some of the columns.

CHAIRMAN POZEN: Well, can I follow up on that? I guess the implications of this sort of schedule is that you would have the potential for two EPS's: one where you would have what we have now for EPS, and the second is you would be dividing between those things that are sort of coming out of core earnings versus fluctuations in the trading portfolio or in currency, maybe even unfunded pension liabilities. So, the unrealized paper losses or gains that then -- some of which flow into the income statement and some of them don't -- would sort of be captured. So, what a company would have and in talking to analysts and talking to investors is the ability to say this is sort of our core earning power, and then our income statement includes a number of these factors which move around and we're not, you know, and they'd move for market reasons, currency reasons, et cetera.

And this was sort of our attempt to deal with probably the debate on fair value. Well, we're not going to solve it here in this Committee, but to try to illustrate and drive home to investors that there is really a difference in the quality of earnings between one sort of core earnings and these other things. So, that's what we're really trying to get to. And we'd really like feedback as to whether or not those sorts of things make sense.

I mean, we're essentially taking the active securities portfolio, the fluctuations and segregating it out. We're taking some of these things that are now hidden away -- what's that part of the balance sheet -- oh, right, OCI and sort of making them a little more salient.

So, that is the basic idea. And we would like to get feedback as to whether that does lead you to sort of two EPS's and whether that makes sense.

MR. CONN: What are the two EPS's?

CHAIRMAN POZEN: You've got to speak up a little.

MR. CONN: Yes, could you hum a few more bars about the EPS's? I'm not following.

CHAIRMAN POZEN: Well, I think the implications are that if you take your overall income, your overall EPS, and you were to segregate out these things like the gains and losses on your trading portfolio or currency fluctuations, these sorts of things, so then you would have a second number which would say, you would essentially say the total minus A equals X. And so, you sort of have a, here X then would represent some sort of core earnings EPS because it would have segregated out these fluctuations because they're not realized gains.

MR. CONN: Right, but some of those fluctuations are part of the regular business of the company.

CHAIRMAN POZEN: Well, that is --

MR. CONN: Like a financial institution, the trades, that, you know, whether it's realized or unrealized, for treasury bills it's probably not very important. But I understand your point if you're saying, and we see this for oil and gas companies who are not doing hedge accounting. They're marking to market their derivatives. They found hedge accounting to be too complicated so they report the mark-to-market on their derivatives outside of core earnings which is, I think, one of the points you're making, Bob, that might be useful.

I don't know whether this would be useful or not because I'm not a user of financial statements. I do believe that it would be complicated to prepare. And so, there's really two issues: can it be done by companies, but also is it useful? I think it would be complicated to do but I don't know if it's useful or not. That's --

CHAIRMAN POZEN: Well, I agree with your point certainly. Financial institutions represent a special challenge in terms of what's core and what's non-core. But we're still looking at the general concept. I don't know whether anyone else wants to comment?

MS. BERGEN: Yes, I do. I think that there's a lot. This schedule raises more questions in my mind than it provides me with answers, primarily because how you define what's up-rating, investing and financing I think are very different for a manufacturing or retail company than it would be for a financial institution. And I think that's one of the key problems for financial institutions with the cash flow statement today.

But I think what you're trying to get at is what is the mark-to-market, and I think that you could simply disclose that information. We're already disclosing what the mark-to-market realized and unrealized on the level 3 assets which are your most tentative valuations. So, if we were required to break out our principal transactions line between commissions fees and mark-to-market, I think you've got the information you're looking for without creating a huge reconciliation spreadsheet.

I'm not sure that cash basis earnings is meaningful. I think that's why GAAP says accrual basis earnings is the right way to go for corporations. Cash basis revenues and expenses are manipulable. When did you send out your last batch of invoices?

CHAIRMAN POZEN: I think we would tend to see sort of systematic accruals within the operating income as opposed to, I mean, these are difficult questions but I think we would tend to see systematic accruals within operating income. And I guess the motivation here was to look at what companies put in their earnings press releases which gets pretty quickly to a core earnings cash notion.

MS. BERGEN: Well, I was sort of positive. If you look at your sales, if you're only interested in the accruals that are still in effect at year-end, look to your balance sheet. You've got it, that's your accounts receivable. But if you're looking at how did the company earn its money, were they truly cash sales or were sales for credit, and then you had collection on those sales, you're looking for different kinds of information. Are you looking to those cash flows to be cash in/cash out or just the net cash flow for sales, for example? And you'd have the same sorts of questions about every other item on here.

This kind of a schedule I think raises lots of questions about feasibility. I think you can more simply get to the tentativeness of the reported earnings through a couple of other key disclosures.

MS. BIES: I think Ed's got one more question.

MR. McCLAMMY: One follow up question was for Brooke. You had talked about you thought it would be helpful to fair value contingencies. And I guess I struggled, maybe you can help me, if someone from your accounting organization came and said I have to fair value this piece of litigation that we're facing where someone has sued us, how would you suggest that they go about coming up with a fair value to put a single number into the P&L?

MS. RICHARDS: Probability-weighted model. So, most companies would have a whole list of contingencies and they assign some sort of probability to that, maybe not numerical but at least qualitative probability. And then, from that, I think you could probability weight all amounts and come up with a single estimate.

MR. McCLAMMY: And who is going to be in a position to put those probabilities down there for a litigation? Are we expecting -- maybe I should ask the attorneys. Are the attorneys who are present today, who would be willing to put a precise probability number on a piece of litigation?

MR GRUNDFEST: Zero.

MS. GRIGGS: Most of us wouldn't.

MR. McCLAMMY: I'm sorry?

MS. GRIGGS: Most of us wouldn't. And most kinds of litigation you couldn't do that. I guess there's some routine litigation that you get all the time; those you could probably put some probability weightings on. But certainly there is an awful lot of uncertainty in how litigation will turn out and I think a lot of it, I mean, lawyers are certainly not in a position today to put weightings on most of that.

MS. RICHARDS: No, I think some of them might have a zero.

MR. STEWART: But when you have a binary outcome like 100 or zero, and those are the only two outcomes, and you say, well, they're about 50-50. So, if you could come up with those, which, you know, I don't know, I couldn't do it. But if someone could, then you'd book 50 which is a number that will never happen. You're either going to pay 100 or you're going to pay zero. So, the 50, I'm confused why that would be helpful to somebody.

MR. McCLAMMY: Right.

MR. STEWART: But, so I'm kind of with you on the contingent liabilities being difficult, but the FASB is moving more toward where Brooke is describing as I understand. And IAS 37 --

CHAIRMAN POZEN: I think it's --

MR. HERZ: IASB has been moving that way. We have, we're still at the kind of threshold in all of that. In fact, even the business combinations, we've backed off of in that as far as front booking of things. So, my own view on that would be, in your example, you could show the 50 but then the underlying information, any point estimate is no good without understanding the underlying information, the distribution underneath it really. That's really where the richness of the information is. But the point --

MR. STEWART: 141R requires fair value of lawsuits. If it's more likely than not you're going to lose, you have to fair value it. Hopefully Linda can do that.

MS. GRIGGS: It would be a challenge.

MR. STEWART: I mean, we're going to have to do it under 141R starting next year.

MR. HERZ: Not for all of them.

MR. STEWART: The ones that are more likely than not, you'll have to fair value them. I think that would be --

MS. GRIGGS: And those are the ones that are assumed in litigation. So, maybe there's some analysis done in, not litigation, assumed in an acquisition, maybe there's some analysis done at that point. It's going forward that I think is very difficult.

MR. STEWART: I think it will be difficult even for the ones in acquisitions.

MS. RICHARDS: Well, currently, we do have some contingencies on the balance sheet, so contingencies that are probable, then there is, you know, the 141 contingencies that are going to have to be fair valued. And you talk later about competing models. So, I would want to know what makes some contingencies different than others that they should get a different model.

MR. McCLAMMY: But I think under the current accounting, it's under FAS 5 for those contingencies, and there's a probability aspect. But once you have the probability aspect, you go to, if there is no best point, you go to a range, then you're accrued to the bottom of the range and disclose the range. And in my mind, that's very different than saying pick a point, that you're forced to say there is no range, you have to pick a point.

MS. RICHARDS: I don't know if you have to pick a point. You have to model scenarios and assign a probability to each scenario instead of just picking one point estimate.

MR. NEUHAUSEN: But in the end, after you model the probabilities, you mathematically come to a single number.

MS. RICHARDS: Yes. I'm not saying it's easy.

MS. BIES: Okay. I'm going to move on now to the next topic because we're running out of time for our Subcommittee's ability to ask questions. So, we want to move on to bright lines. Let me just sort of reference the questions that our Committee is going to ask about this.

The whole purpose of this big Committee is to deal with complexity. And part of what our Subcommittee has been looking at is we have developed over the years a lot of bright line tests. And we've seen where a lot of transactions get structured to be on one side or the other of that bright line test, whether it's leases or I could argue what's more relevant in the last several months, a lot of the structured CVO's, CLO's, various kinds of securities that are out there, or liquidity guarantees or whatever that have popped back on financial institutions' balance sheets, and created losses that really weren't being recognized in the financial statements.

So, we really have two areas of questions we would like your feedback on. Many people have told us that they like bright lines because it simplifies things, so keep them because we're trying to make accounting less complex. On the other hand, with all these surprises that are coming and the structuring that goes on, are we better off going to something that is a framework that is more proportional? So, it isn't all a light switch you turn on and off for recognizing a capital lease or for a securitization where you're managing the securitization, and you're going to provide all the liquidity when it gets into trouble, so basically you still have the exposure. Should you just go ahead and recognize it proportionally all the time and not only when it hits bottom and you've got to come in as a savior of the structure?

So, if you could talk a little bit about bright lines in general, and whether you see it as a complexity issue or whether you see it as something that could be handled in a different way than have the bright line test. Linda?

MS. BERGEN: Yes, I think bright lines can be useful in certain circumstances if they are not definitive on off switch but if they're giving you a sense of what's the principle underlying the standard. So, for example, using equity method accounting, there's that 20 percent threshold for significant influence but it's not a firm 20 percent, it's 20 percent and then you look for the indicators of whether or not you in fact have significant influence. But it gives you a sense of where the thought process was in developing the concept of where it's appropriate to use equity method accounting.

Similarly, well, let's see. It's kind of an anti-abuse provision. And so, it says if you're in this neighborhood, you ought to be considering whether or not you have significant influence. And I think that makes a lot of sense.

To use proportional recording, you might not be able to do proportional consolidation for an equity method investment that you have. You may not have access to that information or you may not have it on a timely basis in order to incorporate that information in your own financial statements. So, I think you have some trouble there. Also, how low would you go with your proportional recording if it was 10 percent, if it was 5 percent? At what point does it no longer make any sense to record your proportional share of the assets and liabilities, revenues and expenses of whatever it is that you're doing proportionally?

So, I think there should be some threshold before you would even consider proportional recording.

MR. STEWART: I think, I would say that bright lines have their place. I'm more upbeat about bright lines than the tenor of your report. And I'll give you a few examples where I think it's quite useful and some examples where it's not including proportionate.

Let's say that the standard says you need to classify cash and cash equivalents in a certain way which Statement 95 says to do. So, what is a cash equivalent? Now, if we sent Bob, he could come up with maybe a 92-day cutoff, and Susan could be 30, and David could be, well, anything that's trust preferred is okay because it's liquid. Everybody would come up, I suspect, in good faith with a different answer. And I'm not sure that's useful.

The FASB said 90 days is a good cutoff. I think that's a very practical solution that results in comparability, that the users understand. They know that bright line, it isn't hurting anybody. Society wins because everybody doesn't have to go out and create their own model.

On the other hand, lease accounting is I think an evil bright line, if you will, and I think Statement 13 is absolutely broken. The FASB is right to reconsider it. And that plays well to a proportionate model. If you're leasing half the life of the asset, then book half of the liability. Absolutely.

Consolidation, it doesn't work proportionate. The model is control. You either have control or you don't have control. You can't do proportionate in that case.

So, I think standards setting is a real art and the standard setters should use bright lines when it achieves a particularly good outcome and should stay away from them when they don't. And that's not easily defined, but I'm more upbeat about bright lines than the tenor of your report. There's a hundred examples, like the cash flow one. There's two or three in 123R, there's a six-month test, there's a 5 percent test that actually are very helpful to practitioners, and I think helpful to users understanding what the speed limits are.

MS. RICHARDS: I would avoid the use of bright lines unless they're really necessary. And I think that if you can have a more robust principle and encourage looking at the substance of a transaction, and I liked Hypothesis 3.2, talking about training in substance and getting people to step back and look at what, you know, instead of focusing on rules – rules and bright lines -- what is it that I am looking at here? What is the economic phenomena and accounting for it in that way? And I know that would be judgment, that would encourage judgment calls, but I think bright lines cause complexity and structuring opportunities.

MS. BIES: Ben?

MR. NEUHAUSEN: In our comment letter, we suggested a little bit different way of looking at it. The Committee used the term proportionality, and we thought really another way of looking at it is to say as the standard setter approaches the accounting for a class of transactions, the ideal would be to come up with one accounting model for that class of transactions. So, for example, all leases, picking leases as an example, all leases would be recorded on the balance sheet by the lessee based on the right to use the asset and the obligation to pay rent. So, we'd have one model effectively say all leases are capital leases but you'd measure them based on the terms of that lease rather than having two different categories of leases: operating and capital.

Now, we used to have two different categories of business combinations, purchases and pooling of interests, and a horrendous set of bright lines to differentiate them. The FASB swept all that away with Statement 141, said all business combinations are purchases. So, the ideal solution is to have a single model for a class of transactions. But that will not always work.

Now, there are some classes of transactions I think the standard setters are going to conclude -- let's say it's sales of financial assets, transfers of financial assets -- the standard setter most likely is going to conclude that they don't all fall into one bucket. They are not all sales, they are not all collateralized borrowings. And so, then you do need some dividing line between the two different models.

And I think your report identifies three different approaches. You talk about bright lines, you talk about presumption, and you talk about indicators. And I think each of those have their place in certain situations. You know, Linda referred to the presumptive approach that we use for non-controlled investments, deciding whether to use equity method where there is ability to exercise significant influence, or use cost method because there is not ability to exercise significant influence. And the standard says there is a presumption that 20 percent is the dividing line but you can overcome the presumption based on the preponderance of the evidence.

In practice, that has worked pretty close to a bright line. I bet 99 percent of the time companies do follow the 20 percent presumption, so the result is very close to what you'd have for a bright line. But there is a little bit of give at the margin and companies can look at individual facts and circumstances.

Now, I think a downside there, when you have a presumption and allow it to be rebutted is that only those companies who want to rebut it are going to marshal the evidence to rebut the presumption. It's not necessarily going to be an even-handed analysis of all the facts and circumstances.

The final point I wanted to make goes to something that's in your report about economic substance. And I'm very leery of thinking that accountants in practice can take either a presumptive approach or an indicators approach and analyze a transaction and come up with the economic substance in a neutral way. I guess I've been in the profession long enough and been through enough good faith arguments with people who disagree vociferously about the economic substance of transactions to think that that's going to get any consistency in practice.

I think, ultimately, the economic substance has to be judged by the standard setter. And that should be part of the basis for conclusions in the standard, how the standard setter analyzes the economic substance, and practitioners and auditors should abide by that. I just don't think it's feasible to have every practitioner, every preparer making an independent judgment on economic substance because they will be inconsistent. In good faith, they will disagree on the economic substance of the transactions and they'll come up with different accounting. And I just don't think that is a feasible approach to have decisions --

MR. KROEKER: Bob, two quick things. I've been told that people who have dialed in should now be able to speak --

CHAIRMAN POZEN: Okay.

MR. KROEKER: And we have a request from those listening online. I guess they're interested in what you have to say and they can't tell who's talking, so if people can introduce themselves before their comment, that would be excellent.

MR. STEWART: This is John Stewart. I'd like to pile on Ben's point about the economic substance. A long time ago, when the FASB began consideration of securitization accounting, it led to Statement 125. I was convinced that I knew the economic substance of a securitization. And I thought they were all borrowings, that they all belonged on the balance sheet. And I wrote very lengthy letters and articles about why I thought I was right.

I sent that to the Chief Accountant of the SEC at the time who also I had great respect for or I had great respect for, and he called me back and said, John, you're absolutely wrong, that the economic substance of these are sales. So, here I thought were two, I thought I was principle-based, he was principle-based. I thought they were all borrowings, I still think I'm right, by the way, and I think he probably thinks he's still right, but he absolutely disagreed with me about what the economic substance was.

So, we had the same facts. And if the standard just said follow the economic substance, I believe that would create chaos in our financial reporting. So, I agree a hundred percent with Ben's comment.

SPEAKER: Right. Well, I do agree with Ben.

MS. BIES: Kevin Conn. Can I --

MR. CONN: Yes, Kevin Conn with MFS. I have to admit that I'm much more of a fan of the proportionate accounting model. I'm not an expert at lease accounting. But the rule-based things for financials creates a lot of exotic off balance sheet vehicles which are a testament to the creativity of accountants but which are not -- you know, in my investing career, many times those vehicles have come back onto the balance sheet to create meaningful asset losses, to create meaningful liquidity risks. And the argument is that they're low probability or that they are safe assets. But I've seen it too many times that they are either unowned by any entity or that they are mismatched in terms of asset duration, liability duration.

And I don't think that the issue is with the broad sweep of off balance sheet assets and liabilities, but for a portion of it. I think that there should be either more disclosure or more estimates of probability of coming back on balance sheet, or more. I mean, I don't know, there is something in many financial statements, maximum probable loss or maximum possible loss for off balance sheet vehicles and for SPE's. And it's usually a huge number and there is absolutely no reconciliation of how they got to that huge number.

It can be tens of billions. It can be between 100 and 200 billion. And there is no explanation given for how they got to that number. And yes, it's very, very unlikely, but capital markets are volatile. They are unstable. They are not liquid often. And so, to pretend that they are I think is quite dangerous.

MS. BIES: Jeff Mahoney?

MR. MAHONEY: I generally agree with Brooke on this point. I mean, we have a number of examples of bright line tests that have created very detailed, voluminous guidance.

MS. BIES: Could you speak up a little louder, Jeff?

MR. MAHONEY: Excuse me. We have a number of examples of bright line tests that have created very detailed, voluminous guidance to try to maintain that bright line. And we have a number of examples of financial engineering around those bright lines. The SEC staff talked about this in connection with their report in response to Section 401(c) in Sarbanes-Oxley. And they generally requested that the FASB try to stay away from bright lines, and I think that's the right approach.

I'm sure John is correct that there are some good bright lines in the literature. But I think in general we should try to avoid bright lines because of the problems that result in the complexity of literature and the financial engineering, neither of which are good for investors.

CHAIRMAN POZEN: Well, I think, I guess I was trying to get some more reaction to what we might recommend in the area of off balance sheet accounting. I think we all agree that securitization is a positive development and we don't want to close it down. I think the question is what sorts of disclosures should the sponsors of off balance sheet be making at what point, and what exactly should be there.

So, I was hoping that we could get some input. We have some very big issuers here of -- users of off balance sheet -- and I think sometimes it is a little disconcerting to the investment community when all of a sudden 20 or 30 billion dollars are taken onto the balance sheet of a financial institution. So, the question is what -- on the other hand, we don't want people to disclose things that have very low likelihood of probability so I'm trying to get some input as to what -- might be a reasonable suggestion for us.

I don't know, Linda, do you want to address that?

MS. BERGEN: Well, I think Citigroup is -- Linda Bergen from Citigroup. We have greatly enhanced our disclosures in our fourth quarter, our annual report, in our 10-Q that soon will be filed today. We've added even more disclosures. We have extensive disclosures about the kinds of off balance sheet vehicles we have, what our roles are with respect to those vehicles, when we have made a decision that we now need to consolidate a vehicle, what changed, what caused us to have to make that decision. And we also provide information on our maximum exposures about what we include in those numbers. And we've also added a lot of information about the key inputs in our valuation methodologies.

CHAIRMAN POZEN: So, when did that information on liquidity puts get added?

MS. BERGEN: In the year-end annual report.

CHAIRMAN POZEN: I see. Now, I guess the question is whether -- if I remember the literature, it sort of says you're supposed to disclose informal and formal obligations. So, I mean, was the general understanding that liquidity puts did not have to be disclosed before the end of last year?

MS. BERGEN: Well, they were included in our maximum exposure because those were contractual arrangements and they were in place. It's the question of when we had to actually fulfill, perform on those obligations or when we actually entered into new obligations that didn't exist previously. That's what triggered the on balance sheet activity.

CHAIRMAN POZEN: Kevin, do you have anything to say about those?

MR. CONN: Well, no, the disclosure from Citigroup in the last two to three quarters has been terrific. I really have to say that the amount of detail and the level of knowledge that an investor can take from that has been great. The problem is if you go back to the first and second quarter or to the 2006 10-K, I think with the rationale that it's a low probability that things will come back on balance sheet, a lot of the liquidity backstop lines were included in lines of credit and sort of rolled up into a big number. And it wasn't quite clear exactly what the exposure was.

So, the issue, and I've lived through many of these off balance sheets coming back on balance sheet, created with asset losses, and I go back and do some forensic accounting and say, gee, what did I miss in the Q or the K that would have pointed me to this big asset loss? And I am consistently disappointed that I cannot find any clue or a hint about this loss coming. And I don't think it's more complicated than adding some sort of bond book type description to the assets.

So, just as companies describe their current investment book many of the things off balance sheet are like securities books. Just add some description of ratings, geography, and just a little bit more description of what the assets are, because if it's a common line of credit or if it's a common backstop line, that's not an issue. But if it's something a little bit more exotic with a different probability of coming back on balance sheet, then that's something that investors should probably know about.

CHAIRMAN POZEN: Can I just have clarification on this point? This is Bob Pozen. Are we saying that liquidity puts, if they're contractual for instance, do not have to be disclosed unless there is a probability of their being drawn down?

MS. BERGEN: No, they're disclosed.

MR. CONN: No, they're disclosed off balance sheet, but oftentimes some of the -- well, I'm sorry. Linda?

MS. BERGEN: They are disclosed. You know, we disclose the kinds of contractual arrangements we have and what we estimated our maximum loss could be under those. But they were, Kevin is right, it was grouped in with larger numbers.

CHAIRMAN POZEN: So, they are aggregated into --

MS. BERGEN: Yes.

CHAIRMAN POZEN: Con?

MR. HEWITT: Yes. Last month, Corp Fin issued a letter concerning 157 and the letter was a clarification relating to GAAP. The letter focuses on movements in and out of level 3 hierarchy in 157. They felt the users needed more information as to what went into that number created through your assumptions and range of values and those types of things. And we purposely put it into MD&A on the premise that this financial crisis and this problem that we have with level 3's will go away sometime in the future as opposed to putting it into the footnotes. So, we think it would be helpful for the users to have the additional disclosure, these level 3 items.

MS. BIES: I want to follow up, Con, on what you just said because I think this is one of the challenges that the current situation I think is bringing to the fore. Organizations who are heavily involved in creating and managing these kinds of structured instruments I think do a good job of estimating the risks that they see in there but they are risk-based models. And most of them are not very effective at dealing with systemic risk which is what we've got now. A large part of this is sort of an uncertainty of what could happen.

And so, if you look at the Basel Banking Committee, it's one of the things that we struggled about over the years, you can look and base risk models on what has been observed historically. But when you get a systemic event that is so widespread, the models don't capture that. They're not robust enough to imagine what could happen when it goes beyond one player who is not a material part of that market.

And that's one of the challenges I think, and whatever we do, whether we stick with bright lines or go to proportionality, whether we need to recognize that the uncertainty which is what I call this unmeasurable piece, is something that we just have to realize cannot be quantified in a meaningful way. We can maybe try but everyone needs to realize it just can't be measured. The Basel Committee is still trying to figure out how to measure liquidity risk which is a central part of all of this.

There is, you know, people have been working on this for years who are experts. There is no real model out there to deal with this effectively that anybody is totally happy with. And I'm just wondering if more of the kind of descriptive information would be much more useful than trying to quantify a lot of these things and these instruments. And are we so focused on moment-in-time fair value kind of disclosures instead of the more qualitative that could maybe lay the framework for a user to know what is out there from a contingency perspective of these unusual events? Would that be more useful instead of focusing so much on what drives a lot of the recognition.

MR. STEWART: This is John Stewart. Kind of pick piling on Citigroup some more. I did not, I have not conquered reading their annual report. It's 200 pages with one small picture and it's a lot to read. But there was one, I did bump across one table that I thought was exceedingly helpful to me. I'm not an investor but that I thought would be helpful. It's like on page 86 where they have like three, I think it's, help me out here, Linda, three or four columns.

They have all their SPE's in this one table. They have those that are QSB's and therefore are presently not consolidated, but they got all the numbers there and by category like credit cards and whatever. Then they have those that are VIE's covered by FIN 46R, and those are broken down into two columns, one on balance sheet and one off balance sheet. And then a grand total of everything, and by type.

So, it's your point, Susan, they don't try to evaluate necessarily everything, but you have all the gross numbers in a pretty format, for just a couple of pages, that I really learned a lot and I thought was very good.

MS. BERGEN: Thank you.

MR. STEWART: Did I have the right page number?

MS. BERGEN: I think so.

MR. NEUHAUSEN: One thing that I would encourage here, at the risk of jumping ahead to your preliminary Hypothesis 5 which comments that historically disclosure standards have developed in a piecemeal manner, and that this would maybe be a good place off balance sheet to try and do it in a more systematic way and integrate the GAAP disclosures with the MD&A disclosures and the subject disclosures that Conrad Hewitt just mentioned, and the SEC's off balance sheet disclosures, try to pull it all together in one place in an integrated way.

MS. BIES: Thank you. All right. Let me move on to the last area that we have proposed that we'd like to get your comments on that really deals with a lot of the exceptions and industry specific rules that are out there. We're thinking here about, again, complexity. And so, why do we have special rules for special industries when what we really need is a good general principle?

And Bob Herz won't be surprised at this, to me one of the keys is revenue recognition where those of us in the EITF for years, a lot of the cases that came to us were because we didn't have a good revenue recognition standard. Another example is why does oil and gas have a separate type of accounting than other extractive industries? And I can go on and on.

And we also touched a little bit earlier about the alternative accounting where sometimes you can account for things in different ways. So, we wanted to know in terms of again our mission of thinking about ways to deal with the complexity issue. Are the types of things we have sort of raised for discussion here today areas that we should continue to pursue? Do you like the direction we're going in? And we're open to comments in any of these that you all may have. Mark?

MR. BIELSTEIN: Let me speak to industry specific guidance. And generally speaking, my view is that industry specific guidance is not necessarily all bad. I think there are probably opportunities to get some of the variations out of that. But before you talk about industry specific guidance, I think it's necessary to talk about, to kind of break it into two parts and appreciate that there is a wide spectrum here. But to some extent, there is industry specific guidance that creates specific industry models. For example, investment company accounting, in that it's just a very different fundamental accounting model.

I'm not sure we want to do away with the way mutual funds report their financial information. That seems to me to be a pretty useful approach. But that is a very different fundamental model, so I would not try and do away with mutual fund accounting. Or another one would be broker dealer accounting, similar to that. So, those are kind of different fundamental accounting.

The other industry type guidance I think generally has been developed over the years in an attempt to apply the general principles of what we have in other accounting areas to specific transactions in those industries. For example, oil and gas. Those issues about oil and gas accounting and what do you capitalize when you drill an oil and gas well are kind of unique to that industry. And there are a number of those kind of areas where that kind of industry guidance might very well be appropriate because the transactions are unique to the industry.

Now, I do appreciate the fact that in revenue recognition, for example, there's probably ways that you could bring some of that closer together. But for the most part, I think that even the revenue recognition guidance primarily developed because people were trying to take the general principles of revenue recognition to the extent we had them. Is the earnings process complete? Is the sales price collectable? And try and apply it in specific fact patterns. And I'm not sure that's all that bad.

MS. BIES: Linda?

MS. BERGEN: Yes. I would second part of what Mark is saying in that industry guidance isn't all bad. I think where industry guidance runs into problems is when the industry guidance is describing activities which may be performed by entities that fall within the official scope of that guide or it may be performed by entities outside the official scope of that guide, so that if you were to take those industry principles and let anyone who has comparable activities use those same sets of principles, I think you would get a better accounting solution. And I think that is very much in line with your move towards activity-based accounting.

MR. STEWART: Yes. This is John Stewart. I thought you guys were off base, to be blunt, on the specialized industry for two reasons. One, definitionally, you got it wrong. You know, you say mortgage banking isn't specializing. Statement 65 applies to anybody who does mortgage banking activities. It isn't limited to mortgage bankers. Software development, revenue recognition applies to everybody who develops software, not to a specialized industry. BDO Seidman made these points in their comment letter and I think they're right on.

There's a number of things where I think you got it wrong in terms of that being a specialized industry. It absolutely is activity based just like you're recommending. But you're criticizing, I think, those particular standards because they're industry; they're really activity based.

Secondly, I think there is a market need for incremental guidance. I one hundred percent agree with Mark and Linda that AcSEC and other bodies, they aren't just making this up for fun. I mean, there has been an expression of a need, there is a void, to help practitioners take general standards and get them down to their particular industry, the airline industry or whatever.

So, I think you guys are off base on this industry thing. You are too harsh on it. It is useful and I think you definitionally got it in part of it wrong. So, that's kind of blunt but that's what I think.

And I don't put it in the same category. You teed this up as these are all about exceptions. I don't think the industry guidance is necessarily an exception from our general accounting standards. So, I don't put industry guidance with the scope exceptions or alternative models at all. I think they're a completely different category.

MS. BIES: Any other comments on this topic? All right. I guess we've got a couple of minutes, so I guess, why don't we conclude by letting any other members of the Committee, anybody else have any questions? Jeff?

MR. DIERMEIER: On all topics? Just a point of clarification earlier, maybe related to something you said, Kevin. My understanding, and Russ certainly could clarify on this, and that is that 157 suggests that companies should not basically value assets at fire sale prices. Is that correct?

KEN: You're right.

MR. DIERMEIER: Okay. So, that gets to the issue that Joe mentioned, this is Jeff, Joe might have mentioned earlier, and that is I think the entire effort here seems to be focused on trying to come up with an unbiased estimate of what might be the current value. Even for a current value of a loan, just from the standpoint of an investor, there are transactions going on in the marketplace at securities prices and they're doing that on the basis. It's just like looking at an NAV for a mutual fund, trying to understand basically as much information as they can about the nature of the business and a loan that may be deeply underwater but likely in the future could generate a higher rate of return because it's basically in difficult shape. And as a result, at this point in time going forward, has a higher risk premium. And therefore, might earn a higher rate of return but there is risk that it may not pay off at all.

It's something that is very valuable to the marketplace in understanding the kind of book because you're comparing two companies that on the surface look identical, but one is running a much higher book of business than the other. By definition, the marketplace needs that information to be able to put a different risk premium and price listings differently.

So, it seems like there's a little bit of misunderstanding here about the notion of, certainly in the current marketplace a lot of people think securities have been marked down to a level that they're bound to bounce back. Well, that's quite a market judgment. As a former investment professional running a firm, try doing that all the time, I'll tell you our performance would have been just terrific.

At the same time, we also could look at some cost price values that are out there and you could say, “Well, they're certainly not very representative.” They are clearly biased from that particular standpoint. So, the effort here to try to come up with an unbiased estimate I think is really what we're talking about in terms of a lot of these financials.

But there seems to be a lot of confusion, Kevin, out there in terms of the notion that firms somehow are marking down to fire sale prices. Why do you get the sense of that?

MR. CONN: Well, one example of that is, I'm not going to name the name of the company, but they have an asset-back security that's backed by student loans that is guaranteed by the federal government trading at 87 cents on a dollar. And many people in the room probably say that's worth, the federal government is probably worth 99 or 100, you know, a dollar, and yet they are forced to take a 12-cent mark on that. And they try to describe that to investors and of course we're skeptical sorts by nature and we're like, you know. But the burden on the company is to go through and say, “Look, these are irrational prices.”

I mean, and I don't know how you define this, it goes back to how you set pricing, but that's clearly one example that it's irrational. And many will say, “Look, they're not going back to par but they're not worth 40 cents, and if you make us mark into 40 cents, then we're going to have a huge balance sheet problem. We're going to have to issue a lot of equity, and then we'll be overcapitalized a year out when these things bounce back.”

And I do think it varies asset class by asset class. Obviously, the student loans that are federal guaranteed are a unique example. There are some that are not coming back. But that's sort of a lot of the dialogue around fair value that's going on right now.

MR. DIERMEIER: Which gets a lot to the --

MR. CONN: Sorry?

MR. DIERMEIER: To the accounting versus regulatory/statutory capital issues. In the paper itself, in the document, one can read it one way. One can read this as to say that we're suggesting that the FASB needs to slow down, that they've gone too far, that they've been too aggressive with fair value accounting. Is that the sense of the panel? Or is the panel's sense as mine is, the sense of PriceWaterhouseCoopers, CRUF and ourselves and the CFA Institute that actually they're doing a pretty fine job about this?

We want you to get into non-financials, I can understand why that is a whole different kettle of fish but -- I'm sorry, I shouldn't say whole, right, because once you get to real estate property in the value of McDonald's properties in terms of the real estate, it gets a little closer, of course there's those kind of things. But what's your sense in terms of the FASB in their attempts to handle this whole fair value issue?

MR. STEWART: I wouldn't restrict them if they thought that was useful, but that they need to talk to users. You know, on the non-financial, none of the surveys I have seen have led the users to be crying for fair value information. Mr. Grundfest raised that question earlier. I think users aren't interested in it from what I can see. Their non-financial things are quite different than financial things because a treasury bill is worth the same whether Susan holds it or David holds it, but a plant can be worth very different things depending on how it's used.

And so, but I would, if I were you, I would not recommend that the FASB restrict them or require them not to do more fair value. I'd leave it up to them, the FASB and the IASB. I mean, I think they should be cautious about it and let the marketplace catch up in terms of how to do it in operationality issues. But I don't think your panel should say stop or anything like that.

MS. RICHARDS: I agree. As I said before, I do like fair value, that I would move slowly, take caution and make sure that it's operational and useful.

MR. BIELSTEIN: This is Mark Bielstein. I guess just to follow on with my earlier comments, I think there's really two sides to fair value. One, the user perspective, and I'll let the users address that. From the preparer or auditor perspective, although there are challenges in trying to deal with fair values particularly when you're getting to level 3, I think as I said earlier, I believe overall the use of fair value for financial instruments will eliminate more complexities than it creates from the preparers, the auditors in just many of the issues that we deal with.

MR. MAHONEY: Jeff Mahoney. I agree with that comment.

MR. SIDWELL: Can I ask a follow on question to Kevin? Some of I think why fair value was being used for financial instruments is to make it irrespective of intent. In the example you gave where you have a difference between the current price of a security or instrument and what is perceived as fundamental value, in that scenario, the one you gave, how do you feel if a company begins to sell those securities? So, it begins to realize the current marks they have it valued at, and basically the marks they had are very close to the transactions that they have.

So, for instance, Coulter & Company's 331 has those securities valued I think you said at 60 cents, 70 cents on the dollar and -- to realize a portion of that portfolio at those marks. How do you feel about that? And how would you deal with the fact that as people look at concentrations, people tend to say, you know what, irrespective of fundamental value, I have an over-concentrated position, I don't want to continue to have that level of risk so I'm going to begin to transact?

I think if you look in history, whether it was the Latin America or LDC issues in the 80's, whether it was the highly leveraged transactions sort of a little after the LDC, there's always this history of people saying the markets have now changed. It's about almost as Susan's point about systematic risk, that people say I'm too concentrated, I no longer want to take this risk, I'm going to reduce my positions when I can. How do you reconcile those two views in what you are suggesting?

MR. CONN: You know that you raise a great question, David. I just, some of the observable prices, if you apply them, you know, say someone wants to sell a small piece of a portfolio and you observe those and you think the price is irrational. So, the 88 cents on the dollar for the federally guaranteed student loan ABS, should that firm go price all their student loan ABS's at 88 cents on the dollar? I would say that feels unfair to me. That feels like too harsh a mark.

So, do you have to mark entire books to that low, distressed observable value in a time of crisis, I think is not fair to the companies. Now, I want to make sure that I say this, Dave, in the context that I'm a huge believer in a migration to fair value accounting in general. So, that's the context of it.

But some of the prices now are creating activities within financials which I think are not productive. So, and some of the markets are not liquid and potentially the treatment, a level 3 treatment or a non-mark to market type or a mark to model approach to fair value is more appropriate than marking to an observable price.

MR. SIDWELL: Because it does seem to me, just to push it down a little bit on this, that if you again look at any of these periods in our history, that what the analysts then do is get the detail of the notionals or some other means of saying I now need, I cannot form a judgment about what marks I would apply, and basically value the whole portfolio that way irrespective of holding.

So, I guess I'm struggling a little bit with this, how you lay into this view that some day if it all goes well, they can hold it longer so they'll get more value from it which I view is an investment decision separate from how you value a financial statement today decision. You may want to disclose information that enables people to gather that, but I think history has told us that investors, because I remember the tables about lots of developed countries and it was very explicit what countries and investors put a specific or analysts put a specific mark against -- country and said, you know, X bank is undervalued to the tune of X billion dollars based on those marks.

So, I don't know how we implicitly put into an accounting model this aspect of duration of being able to hold on to something to realize fundamental value.

MR. CONN: You know, it's very hard, David, to defend having assets on bank balance sheets that are way off fair value for long periods of time. I'm not suggesting that in any way because that can create a whole other set of issues.

MR. McCLAMMY: Susan, can I? I just wanted to clarify the position because there is some discussion of we shouldn't tell the FASB to stop their efforts in looking at fair value. A recommendation was that they should be judicious in expanding the use of fair value until they finish their measurement framework process. In no way it was saying stop, it was just saying think and, as someone said, proceed cautiously until you have that framework in place.

And I think we even carved out a couple of areas like 133 that we said we thought it desperately needed to be looked at on the hedge accounting fund and don't wait until you finished the framework to look at that. I think behind that was more an air of concern when we said be judicious, think about where you're heading until you have that framework in place, related not so much to financial instruments and re-looking at how things are currently being done like hedge accounting. It was more our sense that there seems to be a trend moving in the area of more to non-financial assets and liabilities with 141 certainly being an example of that, so saying just be cautious of expanding it into these kind of, these new areas before we have that framework.

MR. GRUNDFEST: You know, correct me if I'm wrong but I think the general consensus of the Subcommittee is that fair market accounting is a very good idea, but we have various concerns about how the idea is implemented, all right. And it's easy to implement in some situations under some circumstances, and I think people can easily embrace it. In other situations, people say fair market value and they assume that simply using those three words solves all problems when the reality is very different and it's very messy and it's very ugly and people just hope that they can slide over the fact that the plumbing doesn't work by simply saying fair value accounting.

And the problem is it's difficult dealing with a standard that people can't implement effectively, especially at a time when it's most important that the standard be implemented effectively.

MR. STEWART: I think your recommendations would be buttressed if you could cite some evidence like user surveys and things. I don't recall that being in your report, maybe it is, but you know, that's what we're all about, right, helping out these users? And I didn't see much reference to them that I recall in your report, supporting the conclusion you just articulated. This is John Stewart.

MS. BIES: Okay. Jeff has the floor next and then we'll come back.

MR. DIERMEIER: I just had a question for Linda, and maybe it's old biases or concerns about European banking institutions. But on the loan portfolios, and I guess some of the work that we've done recently suggest that less than 20 percent, maybe 18 percent of the pools of assets are actually now characterized as held to maturity so that that categorization is going down quite a bit. But does it encourage additional risk-taking on the part of the financial institution if in fact their loan portfolios don't have to see current sunshine?

I know it's been a concern of a lot of our investors in terms of the way a lot of the European banks have conducted their businesses over the years, apologies for those on the phone. But our sense is that this sunshine of having to try to mark those to market because there are very active marks out there in the marketplace, you can sell your loans at above par value so to speak. Aren't you concerned that basically holding loan portfolios at cost and not reflecting the true volatility that is associated with those securities encourages excessive risk taking? Or do you think that somehow the Basel rules or risk rating somehow solve for all that?

MS. BERGEN: No, I don't think that holding loans on your books at cost less an allowance inspires you to take additional risks. And I think your statistics are not quite right about the percentage of loans that are held for investment versus held for sale. I think a much greater proportion are actually held for investment if you look at loan books versus what's actually categorized as loans held for sale. I can't give you a number. Certainly, at Citigroup that's not accurate.

I think that the allowance process is a very troubled process because of what GAAP requires today, and that is that it doesn't allow you to take into account estimates for loans that have not yet been evidenced deterioration in value. It has to be inherent in the loan already. That doesn't make a whole lot of sense to me.

But to require that you record loans at fair value may or may not be appropriate depending on the kind of loan it is. Yes, credit card receivables can be securitized. Yes, Citigroup is a huge securitizer of credit card receivables. Mortgage loans can be securitized but there are many other categories of loans that are not quite, that don't have an actual market for them, of various commercial loans you're not going to securitize.

MR. DIERMEIER: But you would agree though that most of the change in those values would be due to general interest rate conditions?

MS. BERGEN: And credit. Oh, the changes --

MR. DIERMEIER: And credit.

MS. BERGEN: And credit. Clearly, credit is a big factor with loans.

MS. BIES: Okay. Greg, do you have a question?

MR. JONAS: I want to address industry guidance to come back to that topic for just a minute because I, let me replay back what I think I heard. I want to make sure I got it right.

It seems to me that those of you who, and I think it was most of you, who are fans of industry guidance were fans to the extent that the industry guidance is activities based and apply to all transactions across all industries of that type. So, really to the extent there's activities based guidance in industry guidance, it's really a misnomer to call it industry guidance. It's really transaction guidance, no different than the transaction guidance that exists all over the literature.

But I would also think that there are some examples of industry guidance that are just plain industry guidance that contradict, if it wasn't an activity being done in that industry, the accounting would be different. Are there no such examples of pure industry guidance that contradicts general guidance? And John, you are articulate in this matter.

MR. STEWART: I think there are some. But if you go down the list in your Appendix B, you know, a lot of them are activity based.

MR. JONAS: Yes.

MR. STEWART: You list them as exceptions, kind of bad, and they're not bad. They are activity based.

MR. JONAS: Right.

MR. STEWART: In addition, even the ones that are industry based, I think in part they're trying to apply a broad principle. You know, like there are some special transactions, AcSEC is working on airlines, Ben, you could help me out on this, you know, what's a lease? Well, there is a broad standard that tells you what's a lease. Well, it's in EITF Issue 01-8. But in applying that to the airline industry, it's helpful to get some incremental thoughts from experts so that practitioners don't have to invent it themselves. It seems like that's a good thing for society that people don't all have to go research exactly how 01-8 applies to airlines.

So, I think you're right, Greg, there are some that are like that. But I don't think, on balance, I think having grown up in specialized industries as a young auditor, banks, insurance companies, broker dealers, we would have been lost without some industry guidance. Our clients would have been lost. We auditors would have been lost because the broad standards are way too broad to be operational.

So, on balance, I am in favor of industry guidance. I think your report is on balance negative. And yes, it's not pure either way, but on balance I think you're on the wrong track.

MR. JONAS: And just one follow-up with you specifically on that. To the extent that we could find examples in industry guidance where it's just plain industry and it contradicts general guidance elsewhere, would you be in favor of at least getting rid of that?

MR. STEWART: Yes.

MR. NEUHAUSEN: And I think Mark Bielstein, this is Ben Neuhausen, I think Mark Bielstein made that point, too, that there is some cleanup that could be done. But I think the overall tenor of the report way overstates the problem and it ought to be focused more on these narrower situations where there is some very specific industry guidance that's inconsistent.

MR. STEWART: If you guys ban it, it will come back. I mean, it's market driven. It will happen. Either the accounting firms will do it or somebody will do it. It will happen.

MR. BIELSTEIN: This is Mark Bielstein. I guess to follow up on that, I'm not sure you can just automatically say you get rid of all of it, Greg. I think there are certain instances where you might look at that and say it's still good. For example, the investment company accounting, it's just a different model. It says if you hold an investment that might otherwise be an equity method investment or a controlled entity, that an investment company doesn't consolidate an operating company. My reaction is that's probably the right answer, but it is different than what we would do in other situations.

I'm not sure, if you really have an investment company, whether it's useful to start consolidating operating companies into that, in their financial statement presentations. So, there might be a very limited number of those situations but there probably are some.

MR. STEWART: This is John Stewart. On that point, I think, Greg, you could even argue that an investment company is activity based. If other people did exactly the same activity and didn't have the label investment company, I think the accounting should be the same. Investment companies aren't the same as operating companies, and therefore, that's activity based.

MS. BIES: But let me follow up on that. This is where I think we're trying to make the distinction. When the investment companies do take, as is happening now, the lines are blurring with say private equity firms, others where they're taking large enough stakes that they can exert control, should that portion of their portfolio be accounted for just like anybody else on equity method?

MR. BIELSTEIN: This is Mark Bielstein again. As I said, if you've really got a good definition of an investment company, and I've had the opportunity to spend a lot of time trying to do that in some work on AcSEC with Ben, I don't think it's necessarily useful to consolidate those operating companies. But that's an issue that obviously different people have different opinions on.

MR. McCLAMMY: But shouldn't it come down to whether they're exerting control? Or if they have a significant enough stake, it's hard to believe they're sitting inactively on the sidelines.

MS. BERGEN: This is Linda Bergen. I think the cue there would be whether they're participating in the governance of that institution because it fits in with their own operations or if it's to ensure that their investment comes to fruition. I mean, the ultimate goal, if you're an investment company, is to realize a gain when the investee either goes public or is sold so that the investors will realize a profit. You're not doing it because you're in the business of doing whatever it is that investee does.

And to make an investment, if a financial institution, for an example, makes an investment in a telephone company, of what possible value would it be to put a bunch of telephone poles on the financial institution's balance sheet? It just isn't meaningful information, even though there might be control being exerted for a certain period of time until that investment is sold.

MS. BIES: But I'll play devil's advocate to the extent that financial institutions, as part of their derivatives trading in energy in that they are getting into activities to manage production of power. Should they not then go to equity method on those?

MR. McCLAMMY: So, the telephone poles don't go on but their earnings or the losses go on.

CHAIRMAN POZEN: I do have to speak up for mutual funds -- I tend to be sympathetic with the notion that of all the industry specific standards, they're actually probably a stronger case for them than others, not surprisingly. But I think it's a rare case when a mutual fund is actually exercised in the control --

MS. BIES: Right.

CHAIRMAN POZEN: This is an unusual case. And maybe in that exception, there should be a difference. But it's an extremely rare case.

MS. BIES: Right. And I think that's the only point we were trying to make, it should be investment activities rather than everything in that company treated the same way to look at the individual activities, what we were trying to get to.

MR. McCLAMMY: I'm sorry. One of the places that we thought it created a lot of complexity of having industry specific guidance is that if someone talked about, well, what if someone else has that type of activity? You know, should they then be applying that industry specific guidance? And there's, I think there's a huge amount of effort that goes into people then trying to keep up with all the different industry guidance and saying where might my transaction fit into one of these other industries.

And every time the FASB looks at a new pronouncement, shouldn't they be addressing where all the exceptions are in those different industries, and then addressing not just let's push them aside but they really should be going through industry by industry and saying does that exception still apply or should that industry be swept into this broader standard? So, it may be a good thing. I think it clearly, for the overall, particularly preparers and also users, I think it does create an overall complexity.

MR. STEWART: This is John Stewart. But I think the point some of us are making is that your report defines this incorrectly. You list as industry specific software development. I think Statement 86 et cetera deals with all industries that happen to develop software, all of them. It doesn't just deal with people who say they're a software development company.

MR. McCLAMMY: Was that in the appendix?

MR. STEWART: Yes.

MR. McCLAMMY: Yes, I've --

MR. STEWART: Well, there's a whole list of them. It's just not, oil and gas is the same. Anybody who does oil and gas accounting follows Statement 19 et cetera. Mortgage banking, everybody who does mortgage banking follows Statement 65. So, I think you definitionally are off base with saying that those are industry specific. They're not.

MS. BERGEN: Can I just address -- this is Linda Bergen. Can I address the question of complexity that Ed raised? I think that complexity is not going away because the complexity in accounting principles is a reflection of the complexity in the business world today. And that is going to be with us. It's only a question of how we get our hands around that complexity and develop an understanding that can be then communicated to investors. So, one way or another, we're going to have to deal with complexity.

MS. GRIGGS: I wanted to go back to the reconciliation chart because both Linda and John made points that I would like to understand better. I'm not an accountant, I'm not a preparer, I'm a lawyer. So, I want to understand what the consequences of the recommendation are.

I thought, as an observer of financial information, that reconciliation would be very useful. But I'm troubled by John and Linda, your observations that it might be difficult because after all our mission is to reduce complexity, not increase it. So, if you could just give me a little color on your observations that it might not be doable to do that reconciliation, I'd appreciate it.

MR. STEWART: Ladies first.

MS. BERGEN: Ladies first. This is Linda Bergen. I think what I was trying to say is are you trying to get at the cash flows or the accruals that are on the books at year end? Because if so, you are already disclosing that in your balance sheet. Or are you looking for all the revenues that were accrued during the course of a year? And then, what portion of those were collected? That's very different information. So, you'd have to be clear about what it is you're asking people to do.

In terms of recurring valuation changes, I think you have an easier way of getting at it simply by asking people to disclose either on the face of the income statement or in a footnote what portion of their transaction revenues are mark-to-market. Principal transactions is typically where a broker dealer or a bank shows the changes in value of their securities portfolios so that, you know, you'll have that information which is in your column D. Column E, impairments, are already disclosed in a number of different footnotes on the financial statements. If you have impairments to your intangible assets, that shows up in the intangible note. If you have other sorts of write-downs, they do get disclosed.

So, maybe you're pulling it together in one place, that's possible. But I am not sure going through the exercise of trying to reconcile this is very useful. Then I think for a financial institution, you have a whole different question of how do you categorize things. A loan for a financial institution is not an investing activity, it's part of their operations. And therefore, the --

MS. GRIGGS: But isn't that inherent in your cash flow statement already?

MS. BERGEN: Well, but in the cash flow statement today, loans are required to be shown as investments regardless of whether you're a financial institution.

MS. GRIGGS: Which should be following that same categorization. But what I was asking is, is this doable? I understand that you think the information is all available other places. I just thought you had said it wasn't really doable.

MS. BERGEN: Depending on how you set up the rules on what you're looking for, I think you could have very different answers. For example, if we had to show how much money came in through our deposits and how much went out as withdrawals from accounts, you'd be looking at numbers in the tens of, or maybe hundreds of trillions of dollars on an annualized basis. Is that information overload? Is it useful? I'm not sure it is.

MR. STEWART: I was going to comment. Go ahead.

MR. HERZ: I was just going to say, I mean, the schedule is very much like something we have been working with. And the approach as to what's investing versus financing versus operating would be within certain boundaries of management decision. They'd have to then describe what they think is operating. For example, as to, you know, these are what we think are our operations and describe that, obviously for financial institution, Linda says, a lot of what might be -- as investing or financing or somebody else would be part of their operations.

MS. BERGEN: Yes, as long as they have flexibility in the description of what can go into those various categories, you can have it at least come up with an answer that makes some sense.

MS. GRIGGS: I'm not saying it's not doable. That was my basic question. Is this doable?

MS. BERGEN: It would require gathering all kinds of data that isn't currently collected.

MR. STEWART: I'd have three points. One, I don't know whether it's useful or not, I'm not a user. Second, I do understand the FASB is pursuing it. My point was an operationality point, not a bookkeeper point if you will. I thought column C, D and E would be in practice difficult to distinguish. They all have similar things.

So, if you mandate that we have to have a C and a D and an E rather than have them all together, that would be hard. That would be, how do I distinguish a recurring valuation change from an other, help me out, hum a few more bars as my friend Greg Jonas says sometimes. Could you help me with that? I don't, you would have to have a lot more guidance and detailed rules, principles, bright lines to help make those distinctions.

MS. GRIGGS: That's helpful, thank you.

MR. McCLAMMY: Wait, wait. Aren't you doing that already when you use phrases like extraordinary?

MR. STEWART: We almost never have extraordinary anymore. We have basically eliminated the notion of extraordinary. The FASB has.

MR. McCLAMMY: I think most of what we had in that column, and this was basically pulled from something that the FASB is looking at, but those two columns you can almost look at as a recurring and the other valuation changes that is changes in fair values, and whether those were just, if you look at one, it's fair values that you would probably be changing over a quarter, and the other would be a specific event impairment that happened, that would change the value.

So, whether those columns are the correct columns, I think it was more of an intent to separate out cash activity from accrual activity from fair value adjustments. And we'd leave it to the FASB to decide what the appropriate columns are.

MR. STEWART: Good strategy.

MS. BIES: Yes?

MR. EVANS: I wanted to go back for just a minute to John Stewart's comments about the pace of the change in fair value accounting. I thought you made an excellent point which I agree with that it is for users after all that we designed these financial statements and that perhaps we ought to solicit the opinions of users for this and other momentous changes in accounting.

But I'm interested in what your hypothesis is about how users would view Joe's statement about the pace of change from financial fair value to non-financial fair valued assets. And then I'm interested in the reactions of the users that we have in the panel to your hypothesis. Thank you.

MR. STEWART: My hypothesis as to what users --

MR. EVANS: Yes.

MR. STEWART: I don't, and all I know about users is what I read in the newspaper and surveys. So, it's all very distant. The impression I have is, and this may be wrong, the impression I have is users, not surprisingly, are not a monolith. Just like we accountants are not a monolith, like you lawyers -- I don't know if you're a lawyer, but the lawyers are not a monolith.

We all don't think the same way. That's true of users as well. I think the credit analyst types think somewhat differently than the equity analyst types. And so, I wouldn't pretend to speak for any of them.

But the impression I have is, one, they're not a monolith. Two, some are pretty downbeat about ever going to fair value for the operating plant, ever. Some might be more upbeat about it some day if we could figure out how to do it objectively. But I have the impression that some users in some groups would say never to that. The historic cost, depreciation, all that stuff, serves their need.

So, I don't have a hypothesis, I guess, as to the pace of change.

MR. EVANS: But your guess would be that those lovers of historical accounting would predominate? Is that your --

MR. STEWART: Lovers, I'm not quite sure what you mean by that, that sounds a little --

MR. EVANS: Those in favor of the --

MR. STEWART: The surveys I have read, the two PWC surveys in 2007 of users, it's not a survey of them, they did a survey of users, this new European study. I don't know about the CFA, I've lost track. They did a recent survey on financial institutions but none of them -- none of them, the surveys that I just mentioned -- are advocates of fair value for plants.

They don't say we'd like to get there some day. They just say, but again, I'm not a user.

MR. EVANS: Right.

MS. RICHARDS: I guess the question is, is there a way to give everybody everything that they want, because everybody wants different things. And I don't think there is any simple way, but maybe it requires some thought if you have mixed attributes, perhaps you could have, I don't know in the disclosures or a separate statement the current model, fair value model. That would maybe be one way of giving everybody everything, giving people that want the current and the fair value. However, that would cause preparers to have to have a pretty big burden to get fair value for everything on their balance sheet.

MR. STEWART: This is John Stewart. And I'd like to add one thing to my -- I am a user in one small way. I'm a part owner of a company, there are four of us. And we get monthly financial statements. We prepare them and try to follow GAAP. The only real liability we have is a lease. We rent space.

I don't care about the mark-to-market fair value of that lease. I do not care. I'm interested in the rent we pay. I'm interested in our billable hours. I'm interested in collecting receivables. I am not interested -- now, I'm an owner, maybe that makes me not a user, but I don't care about the mark-to-market of that lease.

MR. MAHONEY: Jeff Mahoney. The Council of Institutional Investors doesn't have any policy on this issue. But Mr. Diermeier can correct me if I'm wrong, but the CFA Institute has long said that fair value information is the most relevant information for financial decision making. They've gone on to say that our goal is for fair value to be the measurement attribute for assets and liabilities, not just financial assets and liabilities, assets and liabilities.

I agree with John that not all investors agree with the CFA Institute on that point, but I think many do. And certainly, then when you go to the issue of financial assets and liabilities, I think there is very broad support in the user community for full fair value for all financial assets and liabilities.

And I'd say, in response to John, I think that some users oppose full fair value for all assets and liabilities because they think they're going to lose historical cost and other information. I think if you survey them and tell them that you won't lose that information, that that will also be provided, I think you would have pretty broad support for fair value for all assets and liabilities from the user community.

MR. EVANS: So, it's your assertion that there is a strong consensus among institutional investors in favor of aggressive deployment of fair value accounting across asset type? Is that, did I hear you right the first time?

MR. MAHONEY: The Council of Institutional Investors does not have a policy on fair value accounting.

MR. EVANS: No, I understand. But you're referring to the CFA --

MR. MAHONEY: I think CFA Institute is one of the major user groups in this country and their position is pretty clear on this. And I think a lot of, not just their members but other users agree with that position.

MS. BIES: I want to play devil's advocate on this for a minute because as a former bank examiner, and I think looking at what's happened in the financial markets, making loans based on collateral fair value of assets and liabilities with ignorance of what operational results are and what cash flows are is what's gotten us in the dilemma that we're in. And fair value of all assets and liabilities seems to me just like John pointed out for his company in their own lease, what I'm interested in is what John's operating results are and can they cash flow that fixed payment on that lease. I want to know about it, but to fair value it doesn't really tell me anything.

I just feel that moving to fair value acts very much to create more of these asset bubble kind of panics in the market and that's what these are really, panics. And I really question the users who say we want everything fair valued. Well, you know, okay, but why? What decision would you make?

When we look at the way banks underwrite loans, for example, one of the concerns we've got right now around the optionality of fair value on hedging is their own credit mark. Most debt covenants, when you lend to a company, care a whole lot about how much debt leverage there is in that organization. Now, you've got companies about to go under, and if they were choosing the fair value option on their debt, they'd be writing down that debt. When they write down their own debt to fair market value, that's an increase in their income that adds to their income number which ends up in equity. And so, it's difficult for a bank to enforce the debt covenants that it's got.

It's one of the reasons bank regulators back all that stuff out of our measure of regulatory capital. (Sounds of thunder.) Oh, gosh, I spoke too much. The gods are angry.

MR. WEATHERFORD: There is the answer.

MS. BIES: All right, I give up. But I am very worried about moving toward basing everything on collateral value. I'm very concerned about the systemic issues that we've got. When the real, I mean, when you judge management of a company, you want to know what's happening in the operational results. And that's why we wanted to break out operating activities, and we need to define what it is by each company in what lines of business that they're in.

But to base things on the balance sheet, I think back to the dot com era, too, when all the companies who were entering into these business lines, they were valued based on future cash flows, none of which were ever realized. They didn't even have revenue yet. And the market burst that bubble.

So, I just, I really think people need to say what is the information you want. You maybe disclosed it, but should it be the key measure of recognition in the income statement? I think those are different issues that need to be thought through on these things.

MR. HERZ: Yes, we obviously like this schedule if it could be operationalized. That will be field tested fairly extensively. But I think this kind of either-or, I think that's part of just the logic here in the schedule and project. People say either or, and part of my problem is that accounting does not mirror a lot of economics right now.

This schedule helps to segregate different types of economic phenomena like flows from changes in stock values, changes in values in assets and liabilities. And there are different types of flows. There are flows, there are cash flows, there are the contractual accrual type flows. And then there are all sorts of changes in stock values in assets and liabilities some of which are based on like loan loss reserves, other estimates. Depreciation is an estimate. There is no transaction there. And fair value is another type of change in stocks. And it's not to me an either or.

Now, sometimes it's very important to understand the original cost information. It has impacts on taxes, potential taxes, things like that. It has impacts on estimated replacement sometimes and all that. But to kind of debate over one or the other to me is I think getting to somebody's comment here, that it's not that productive of one because I don't think we need to settle for either or.

The real key is segregating the information based upon different economic attributes and characteristics. And I think analysts, or investors, when they do that, they do this kind of information. They apply different multiples. They'll apply more than a one multiple to flow information. It depends on what kind of flow, whether it's an operating flow core or non-core. They're applying one multiple to the changes in the stock although some of the changes in the stocks that we have here now under existing accounting don't make a lot of sense because they're not economically based.

So, I feel fairly strongly about this after many years of looking at this that it's an unproductive debate to have the fair value versus cost type of thing. And let's get back to kind of fundamental economics in the way people or investors actually try to look at the information and use it.

CHAIRMAN POZEN: Yes, I know Jeff is trying to get into that.

MR. DIERMEIER: I very much support the comments that Bob made there. And for those who read carefully our final edition of our CBRM, it's very clearly stated that we strongly support fair value for financials. And so, you know, softened up a little bit on the non-financial element but still with the theoretical notion that the fair value across whole assets and liabilities makes sense but not suggesting that we prescribe that somehow we just jump right into that.

But, John, I will say to you as an investor that I am very interested in what your lease payment might be two years from now when your lease is up. And I bet you do care about that, too.

MR. STEWART: I do, too, and it's disclosed, so it doesn't have anything to do though with fair value. I'm not an investor but I think --

MR. DIERMEIER: No, but as an investor, I would take that in consideration if I'm going into business --

MR. STEWART: Absolutely, so do I. That isn't the point I was making though. I don't think I communicated that well. Did I or are you confused about that? You are? I agree you need to know the future cash flows from the lease. The question was the fair value of the lease that goes up and down based on the rents, markets changing, was the point that I don't --

MR. DIERMEIER: Doesn't that kind of connect together? That's how that stuff works.

MR. STEWART: Well, I would recommend to your Committee that you look up all these surveys that have been done. And I find them very confusing because some of the surveys of users say turn left. Others say turn right. And I'm not surprised that they're not all saying the same thing. I would just recommend that you read them all because they give you a very different feeling, and I have no idea what's right because I'm not a user, I'm a practitioner.

MS. BIES: Did you have any --

MR. EVANS: No, I didn't have any. I had a similar reaction to Bob's comments that Jeff did. And my guess is if you could put the discussion on fair value in the terms that Bob just did and look at it broadly, look at it as additive to the set of information that investors and users have today, that you'd find a broader consensus.

MS. BIES: Okay. Bob, do you --

CHAIRMAN POZEN: Yes. I wanted to go back, I got from the panel's general thrust that there was less than full enthusiasm for industry-specific standards. But someone said they had a different view, they viewed that very differently than scope or alternative accountings or models. And so, I guess I was looking for a little support in those areas, that if you could explain what you thought about those recommendations and proposals we were making.

MR. STEWART: Well, I think, this is John Stewart, I think you and Susan teed it up and maybe it's in your report that industry guidance was an exception. I think she introduced it today that way and maybe that's the way it's -- I don't view it as an exception. I think a lot of industry guidance is fully consistent with GAAP generally. I think much of what you call industry guidance isn't. It's based on activities like software revenue recognition.

How about real estate? Sales of real estate you list as industry guidance. Selling real estate, Statement 66 applies to every company that sells real estate.

CHAIRMAN POZEN: Yes, okay.

MR. STEWART: It isn't industry guidance.

CHAIRMAN POZEN: I think we understand that. The question is so what about them, but do you support our view that there should not be the scope exceptions and should not be alternative accounting guidance or alternative accounting methods for the same transaction? And then we also talk about use of different models, it's just trying to --

MR. STEWART: Right, okay. So, we're moving away?

CHAIRMAN POZEN: Yes, correct.

MR. STEWART: Okay. Scope exceptions, each of these has their own story, if you will. Scope exceptions, I think, are very much dependent on how the standard setter defines the scope. Just to give an exaggerated example, let's say the scope of this project is accounting for debits. Now, that's probably pretty broad and we might have to have some exceptions to that.

In derivative accounting, for example, and we kind of all pick on 133, has a very broad definition of what a derivative is. Therefore, a simple purchase commitment to buy tissue paper is a derivative. Do we need to account for a simple purchase order to buy paper or tissue paper as a derivative? I don't think we need that to be a derivative. So, the FASB scoped that out. I thought that was a good decision.

2/10 Net 30 on a receivable, a trade receivable has an embedded derivative in it. Do you think it's useful, practical, helpful to people to unembed and separate, bifurcate that embedded derivative in 2/10 Net 30 trade receivable? I don't think that we need to do that. The FASB wisely made an exception for that.

So, if you go down the list of exceptions in 133, scope outs, whatever, I think they were done for judicious reasons. There was an understandability, understandable why they did them. But yet there are exceptions. That, I think, the reason there are exceptions is they defined derivative in my view too broadly. So, they were kind of compelled to make these exceptions.

I think those exceptions in this case are good. If we try to apply 133 without the exceptions, I don't think we could do it. So, but some exceptions are bad, but you know, you're going to have to define it a little bit more precisely I think. It's not, I think to say get rid of all exceptions is not a good strategy. I think the standard --

CHAIRMAN POZEN: I think our position was a presumption against these exceptions and scope exceptions, but that they could be overcome in a particular situation.

MR. STEWART: Well, I think that's all dependent in the art of standard setting and how they define the scope. I think some of the problems we have today are we have scopes that are wrongfully decided or too broad.

MS. RICHARDS: This is Brooke Richards. I'm going to pick on 133 as well because it's the easiest one to pick on. I could pick on 150 I guess as well, too. But I agree with a lot of what John said. I think that a standard with a lot of exceptions may lead you to believe that there is a flaw in the way that accounting standard was written.

So, whenever you get to a point where you're saying, well, what about this, what about that, what about this? Well, then, I think you should step back, a standard setter should step back and say, “Maybe my standard, maybe my principles are wrong.” “Maybe what I'm trying to get at in this accounting is wrong.” 133 was probably defined, I don't know, maybe derivative was defined wrong, maybe exactly what the FASB was trying to accomplish with derivative accounting was wrong. And so, therefore, they had to put a lot of the scope exceptions in.

And then there is also the, the hard part of 133 is bifurcation. The FASB put in an abuse prevention to say that unit of account if you can't embed something, so then what that did was that caused a bunch of other scope exceptions just for one simple abuse prevention provision. And that makes people go out on a witch hunt for embedded derivatives which usually you don't find a lot of them. So, I think that could have probably been written in a better way.

Another factor that causes scope exceptions is a short term fix, and I think that was mentioned in the report. When you have, when the FASB believes there's a short term fix that needs to be done, perhaps it does need to be done, but then that causes a lot of complexity. And so, if there is a short term fix, then there should be some dedication to getting the long term fix done to eliminate that complexity.

MR. NEUHAUSEN: This is Ben Neuhausen.

CHAIRMAN POZEN: Sorry. Can you just, Ben? It's Ben, just to enunciate it for the people on -- it's Ben Neuhausen, yes. I just wanted to tell the people who are on the -- so now please, Ben.

MR. NEUHAUSEN: Okay. I just wanted to add on I think the recommendation from the Committee would be more balanced, I think, if it addressed both the way the standard setter sets the scope as well as suggesting that scope exceptions be minimal. You know, that the scope should be defined very carefully to begin with, and then there shouldn't be as much of a need for scope exceptions. But to just say blanket no scope exceptions without addressing the other side which is how the standard defines a scope in the first place I think is not balanced.

CHAIRMAN POZEN: Thank you. Mark?

MR. BIELSTEIN: Yes. This is Mark Bielstein. I think clearly there are opportunities to reduce some complexity by limiting the alternative policies, scope exceptions, different models, that clearly could be done. But as others have indicated, there are reasons for those things and I think just saying overall that those should be eliminated is troublesome because there are reasons, as people have indicated, for 133, for example, to have scope exceptions.

There's also reasons for different models. For example, the impairment test which I think was one of the things that you all have in your paper. You know, there are probably opportunities to reduce the number of different types of impairment tests or make them more consistent, but I don't think we're going to end up with the same kind of impairment test for deferred tax assets that we have for intangibles or property equipment because deferred tax assets are not measured on fair value. It wouldn't make sense to use a fair value measurement when we're evaluating deferred tax assets. So, to some extent, you're going to have different models because the underlying accounting is different.

One of the areas about competing models which we really haven't touched on this morning which I think is one of the biggest areas of need in reducing complexity is in the area of accounting for debt and equity instruments and trying to figure out which is which and trying to figure out how you account for conversion features and things like that. We just have a number of different models for when we separate things. How do you separate them in all of them? And that is, I think, has got to be right at the top of the areas of complexity that we have in accounting today that really needs some fixes in the near term. And I appreciate that's on the FASB's agenda, has been for a while, but that's something that needs some real fixes there.

CHAIRMAN POZEN: Thank you. Denny?

MR. BERESFORD: There's been a comment that's been made on two, three occasions now, maybe more than that about specialized industries versus activities. And I think John has given the example a couple of times about software development. Mark, I think, gave the example of oil and gas. But it seems to me at a fundamental level we could be talking about cost incurred in anticipation of raising revenues, that that's a real, that's more of a fundamental, it's probably the revenue recognition issue.

I guess the question is how do we parse these things? How do we determine what is a specialized activity versus a specialized industry versus a very fundamental thing like what's an asset, what's a liability?

MR. STEWART: This is John Stewart. I'm not sure your Committee should, if I could be so bold. I think that's what the standard setter should do and make that call. And if we have the right processes and the right people, they'll, hopefully, make the right calls. You guys aren't in the standards setting business I don't think. And I think all the mechanisms we have, the EITF, you know, I'm not sure what we're going through, but IFRIC in the future, I think they've got to be the guys and ladies who try to deal with your question.

When a standard is written, it's so broad a level, everything is interrelated and you're lost as to what to do. Practitioners like me are lost as to what to do. On the other hand, you can burrow too deep, and therefore, you could only apply it to this one narrow area, that's not helpful either. So, it's a real art, I think, to have the right blend of scope, principle, rule, bright line, whatever, and it's different from different things.

So, I don't know the answer to your question, Denny, but I am not convinced that you guys have to decide that.

MS. BIES: Why don't we, now in the time that's left us, I would like to give each of the panelists a chance to make any kind of concluding comments on either something you've already said that you wanted to reassert or if there is something we didn't touch on that you'd like to make a comment on. And if you each would take about three minutes or so, that would be great as we go through it.

John, let me start at your end of the table. We'll just then move on down, if you would?

MR. STEWART: Well, I, you know, let me, as I think I've said, I think accounting is a practical thing. I think it has to be helpful and communicate. I don't see it as a science in which we're trying to discover gravity. There aren't any truths like that. I think it's all about, I think Russ Golden made a speech recently where he talked about he was in the communication business, if I remember right, I agree with that.

And therefore, I think we also have to always be mindful about whether the standard can be actually implemented by regular human beings. You know, if a standard is really cool but it can't be done, that's not helpful to anybody, the auditors, the preparers or the users of financial statements.

I think there's rules versus principles -- I find a dichotomy that I don't understand. I see it in the press. I'm not familiar with how you define a principle versus a rule. I wouldn't know what one is one and one is the other. Thou shalt not steal -- is that a principle or is that a rule? I mean, I think that's, as you guys I think maybe you're getting to, it's not a good productive debate.

I think there are some situations where exceptions are useful, some scope exceptions. I agree with you that should not be the norm, but I think they are useful from time to time. Speed limits are helpful to both users and preparers I think in some cases as are bright lines in some cases.

Economic substance is not a powerful enough concept to be made operational. Ben made that point. I agree with that. I gave my example.

I think complexity is very, is all about, we've got some bad principles like lease accounting. We have overly broad scopes. We have inconsistent principles, competing models that you described. My definition of complexity is quite different than the one you guys have in your report, but I think those are the major reasons for complexity, results that don't make sense, lack of symmetry, et cetera.

I think we do need implementation guidance. We just can't have really, really broad things. I think the world needs an implementation guidance. A recent survey of IFRS users indicates they want some more guidance, more specificity.

And I think, last, standard setting, as I mentioned a couple of times, is a real art. And I think we're going to talk about standard setting later today and it's a real heavy responsibility but it is an art that requires balancing all these competing things.

MS. BIES: Thank you.

MS. RICHARDS: Okay. This is Brooke Richards. First, I want to commend the Committee. I think they're doing a really good job in moving in the right direction. And also, the FASB for what they do. I know, I've been on their side and I know it's not an easy job.

Also, I didn't say my disclaimers that my views represent my own views and not American Express. And I wasn't even able to pull the IMA that I'm representing. So, I'm here as a technical accountant.

I think that the world is not a perfect world and there is never going to be, accounting is not perfect, there is never going to be a perfect answer. But simplicity, consistency, substance are all good things and I think that's what this report is getting at and should be continued. Continuous improvement is always good. It's hard, it's hard for people to change, but it can be done.

Also, just a point of clarification. When I said before I think substance is a really important thing, an economic phenomena, representation of faithfulness of the economic phenomena, I'm not saying that the FASB should just say do that. I think that the FASB needs to say what that is in their standard. And then, I think also as in one of your hypotheses, that it would be good to have some training for accountants and everyone in the profession that it touches to learn to look at the spirit of a standard and take a step back and apply common sense and look at what is the principle that the FASB puts forth in a standard and to apply that. And I think that we would have a lot better accounting if we were all able to do that. I may be a bit utopian but at least it's worth the effort.

As far as principles, I see the principles that the FASB has been working on and they've made a lot of improvements. And I think in my world, John said is 'Thou shalt not steal' a principle? No, and I think that's a rule. But I think 'respect others' is a principle, and that in following that principle, you should not steal. So, that's my definition simple of a principle and a rule.

I think that's about it. So, just thank you for allowing me to present my opinions. And keep up the good work.

MS. BIES: Thank you. Ben?

MR. NEUHAUSEN: This is Ben Neuhausen. I'd like to join Brooke in saying that I think the Committee has done a very good job in teeing up the issues. I think I'd like to focus on two issues in my final comments.

One was something we talked about in our comment letter in terms of opportunities for simplification, and the Committee talked about eliminating competing accounting models. And we also suggested that another area of complication and diversity is the way assets and operations get grouped for different purposes in accounting. We gave the example of the different grouping for segment reporting versus how reporting units are analyzed for purposes of impairing good will, and then how discontinued operations are defined.

There's three very different levels within the company, and we see over and over again in accounting what some of the board members have referred to as this unit of account issue. Are we looking at the individual transaction? Are we looking at a group of similar transactions? And it's very inconsistent from area to area and there's probably some low-hanging fruit to simplify in that area by converging on the grouping of assets and the grouping of operations.

The other thing we really didn't get to talk to today, your new preliminary hypothesis 5 on the disclosure framework is a very good idea. I think that disclosures do tend to grow like top seed because they're done individually project by project. There is some duplication between SEC disclosures versus GAAP disclosures. And it would be good to take a comprehensive look at what it is that we're trying to accomplish with disclosures and then try to rationalize the existing requirements.

MS. BIES: Thank you, Ben. Jeff?

MR. MAHONEY: Jeff Mahoney. Thank you for the opportunity to appear before this group. Before I go into my comments, I want to again emphasize for the record that these comments are my own and do not represent the views of the staff or board or the general membership of the Council of Institutional Investors. Like my fellow panelists, I commend the Subcommittee for its hard work in what is a very difficult area, the topic of substantive complexity in financial reporting.

I think your recommendations with respect to fewer bright lines, fewer exceptions, I think those are quite positive and can have a positive impact on high quality financial reporting and reducing complexity. I agree with John that there's good bright lines and evil bright lines. The extent your recommendations can reduce those evil bright lines, I think that's a positive for investors and financial reporting. And the same thing with the exceptions, there may be some positive ones but exceptions could also create complexity and reduce the value of financial information to investors.

I also would join Ben and I would support the recommendation along the lines of the disclosure framework. I think that's a very good idea. I am the co-chair of the Investors Technical Advisory Committee and we wrote a letter to the FASB supporting a disclosure framework project. I think that can improve the quality of information and the usefulness of information. I think it can also create some efficiencies in the standard setting process if there is a disclosure framework in place that's applied in an ongoing basis. So, I think that would be a positive recommendation for a number of reasons.

There's potentially two areas in your report that I think some investors might have some concerns about, ones that are the one we already discussed about with respect to fair value accounting. I think a recommendation suggesting a delay or deferral of fair value accounting until the conceptual framework is completed, I do not support that recommendation. I think the FASB and the IASB and I think the SEC staff in the past have concluded that the two can be done at the same time and I think the SEC staff has said before in published reports that developing some of the major projects that the FASB is working on including revenue recognition, that the learning from that can be used to develop the conceptual framework concurrently. So, I would not put off moving towards more fair value until the framework is done which we know is many, many years away.

I think the second area that I would just raise as an issue, it's my understanding the Committee's mandate was to examine the US financial reporting system in order to make recommendations to reduce complexity in the financial reporting system. So, I think the mandate is quite broad and I believe at least some investors including this very small investor is somewhat disappointed that the Subcommittee on substantive complexity has focused almost exclusively on accounting standards in the FASB. I think there are a number of other actors out in the financial reporting system. There are a number of other issues out in the financial reporting system that create complexity in that system. It's not just all accounting standards in the FASB.

There are certainly issues there as well and you've dealt with a number of them, but there's much broader issues with respect to complexity in this system. And I think some were hopeful, some investors were hopeful that there would be more recommendations addressing some of these other areas.

That completes my comments. Thank you again for allowing me to participate this morning.

MS. BIES: Thanks, Jeff. Kevin?

MR. CONN: Yes, Kevin Conn with MFS Investments. Thank you also for inviting me to the day today. And as with everyone here, as I read through the report, I was absolutely excited. You know, every proposal I saw, I was like, oh man, this is just a terrific direction to head in, so I want to commend the Committee for coming up with some terrific proposals. The ones I didn't say I'm into are ones I didn't understand. But the rest of them, I really agreed with generally.

The two points we talked about during this session that I have a lot of energy around, one was a little bit more exploration around special purpose entities off balance sheet, a little bit more disclosure, a little bit more detail about what those are. There are many off balance sheet vehicles which I think are plain vanilla. You know, they're not exotic animals, you know, there is no real issue there. But there are some, and I don't know how big it is, but they probably could use some more attention.

The second was this fair value issue around distressed markets. This one is complicated and I don't know what the answer is. But what's happening now in some cases doesn't seem to be fair to the companies and helpful to investors.

And then, finally, the complexity issue is one that I found very refreshing to see in the report. And as a user who sort of, you know, spends a lot of time going through a lot of documents very, very quickly, oftentimes you don't have a chance to go refresh on an accounting statement. And so, anything that can be done to make things less complex would be very helpful.

And anything to help comparability, so I think in part of the document there was something about different alternatives to calculate things, I spend a lot of time trying to get to apples to apples numbers and it's incredibly frustrating. And every company has their special definition of earnings, their special definition of cash flows. And I find it discouraging, the amount of time I have to spend to get things on an apples-to-apples basis. So, just as a sort of theme, all of the things that had been written and discussed and proposed around making things more comparable and simpler I quite agree with. Thanks for having me.

MS. BIES: Thanks, Kevin. Mark?

MR. BIELSTEIN: Mark Bielstein. I think you all have done an excellent job of identifying some of the reasons that we have complexity, whether it's alternative accounting models, scope exceptions, to some extent industry standards.

But for whatever reason, I think we could probably all identify the top areas where there is significant complexity, whether that be derivatives in financial instruments, consolidation under variable interest entities, and Statement 140, debt equity classification, revenue recognition. You know, there are a probably a handful, whether it's five or six different areas. And for whatever reason, whether it's because of scope exceptions, alternative accounting treatments or otherwise are the real areas that I think are important that the standard setters need to focus their attention on. And whether it's due to scope exceptions or alternative accounting models or whatever, I'm not sure it really matters, but those are the areas that I feel strongly that there needs to be some priorities identified particularly with the potential movement towards IFRS and all of those things.

I think, also, it's important to recognize and this is really just an observation and it may or may not turn out this way, but I think it's important to observe that the reduction in complexity very well may increase volatility in reporting financial results. And you know, obviously that depends on what you do to reduce complexity, but because some of the complexity is caused by exceptions, other comprehensive income and those kinds of things, if you do away with some of those, you're going to increase volatility and that's just the potential result.

I also agree with the comments that Ben and Jeff made, that I think it's important to think about disclosure issues and frameworks for disclosure, the way we get disclosures now where it's just a continuing add on list of just about everything you could think of about an area when a new standard comes out. And all of that may be very well and good but it's just gotten to the magnitude where you end up with trying to go through a list of several hundred pages to make sure you get all the disclosures in there. It is not an effective way to continue trying to address disclosure issues. Thank you.

MS. BIES: Thank you. Linda?

MS. BERGEN: Yes. Linda Bergen. I'd like to say thank you for having me come and speak with you today. I agree with many of the issues that you raise in your reports. I think there are opportunities to streamline rules that would mandate using more judgment. And the question I have there is whether variability in judgments would be accepted. People are afraid of being second-guessed if their judgments turn out not to be where the SEC ultimately is, their view is to settle on a particular issue because no one wants to be required to have to restate their financial statements.

I think with respect to specialized industry accounting, I support it where it really reflects a specialized activity. And I think that very often that specialized accounting ought to become generalized GAAP, and so that anyone who engages in those same sorts of activities ought to be able to use the same sort of activities.

There are several comments in your papers that deal with structuring in the sections on bright lines and how structuring is a bad thing. And I think that is misguided. I think that companies will always have objectives and there will always be opportunities to structure transactions, to get companies both the economic and the accounting and the regulatory outcomes that they need in order to have positive business outcomes. And I think that to a large extent, standard setters ought to ignore the said structuring opportunities. I think what regulators and standard setters ought to do is focus on what are the appropriate principles.

Structuring will happen no matter where the line is created. There are some really smart people in the banking community who are paid to figure those things out, and that will happen. And I think you just need to accept it.

With respect to the outcome, bank capital, broker dealer capital, and probably insurance company capital are very key drivers in why companies attempt to structure transactions. And I would point out to you that structuring isn't just changing words on a piece of paper. It's actually changing the transaction so that there is a difference in the economics. Sometimes it may be marginal, but there is a difference. And that can't be ignored.

So, thank you for having me here today.

MS. BIES: I want to just give our thanks to the whole panel today for taking the time to think about these issues and give us your comments and traveling, for some of you, to come to this panel today. So, thank you very much.

CHAIRMAN POZEN: Well, we are now going to take a break until 11:00 o'clock. Some of you are going to come back. And I think there should be, it looks like coffee back there and there are various other things. So, we're going to take a break, and for those people who are on the phone lines, we'll be back at 11:00 o'clock. Thank you.

(Off the record.)

PANEL TWO

CHAIRMAN POZEN: We are now approaching full house. We have one new panelist here, Lynn Turner. Lynn probably doesn't need much introduction to this group, the former Chief Accountant of the SEC, now a professor at the University of Colorado, am I right, Lynn?

MR. TURNER: Oh, I haven't taught for about three or four years. I'm just trying to go fly fishing and stay retired but very well.

CHAIRMAN POZEN: Fly fisherman extraordinaire among many other talents. So, we are now going to have a session which we're going to focus on Chapter 2. David Sidwell and his Subcommittee have done an excellent job in this and I'm going to just hand it over to David.

MR. SIDWELL: Thank you. And as we heard before, thanks everyone on the panel for coming today and speaking with us. We hope, obviously we had sent out the reports in February and in the package of materials that you have for today's meetings, you have an update on some of the thinking that we've done since then. Obviously in terms of process, we're still obviously trying to get as much input as we can. We have benefited from a number of comments in the letters that we've received. We would very much like to get your views.

We thought, what we'd like to do is to begin by asking each of you for what are the top two or three things that you think are issues and issues that we should spend some more time thinking about and to get your views. We would then like to basically look at some of the areas in our reports and some of the points that you make and ask you questions so that we can further our thinking.

So, Linda, I'm sorry, you're at the beginning of the line over there. Would you mind please beginning with some overall thoughts? I'm obviously cognizant of time so I want to make sure that we have time to not just hear from each of you on your overall points but then we can delve down into some of the issues that you raise. So, Linda, thank you.

MS. BERGEN: Okay. I'll start off with a few comments, and I'm sure I'll have more later as other things are discussed. There is an emphasis here on the critical importance of having users involved in the standard setting process. I agree that users should be involved. However, when it comes to users on the standard setting boards, I think one of the difficulties is that, at least historically, many of the users who have been represented on the FASB board have been more interested in disclosure than having a sufficiently detailed understanding of accounting. And I think in order for a user to be an effective standard setter, they need to have both characteristics in order to be most productive. So, that is one of the key things that I think needs to happen in order for the user input into the standard setting process to be most valuable.

One of the things we have noticed in the standard setting process is that the comment letter procedures often seem to be pro forma instead of substantive, that the comments that are received from the preparer community are often not taken seriously. And that has led to a number of amendments to standards very shortly after they have been released. And we think that, I've heard comments that come in from users being summarized glibly as we didn't hear anything new that we hadn't taken into account before. And therefore, there was nothing substantive received, and therefore, board members feel free to go ahead and finalize the standard that's been drafted.

So, I think there has to be greater attention to the comments that are actually submitted. I think in that regard, your request for more field testing would be extremely helpful in bringing to the board's attention what the operational issues are in trying to implement a draft standard. I think it also would be useful for the user community to do the pre-reviews. I like your suggestions there. And that would, I think, avoid a lot of the disclosure that perhaps is never used or never understood, and it would also ease the burdens on the preparer community.

For every new standard that comes out, we can't just push a button. Very often there are significant systems, development processes that are needed, and it takes money and it takes time to develop the systems to do it right so that the effective dates of standards have to be set with appropriate room to get all this work done. Otherwise, people scramble and it's an area that can lead to mistakes that could have been avoided. And I think I'll stop there for right now.

MR. SIDWELL: Thank you. Mark?

MR. BIELSTEIN: This is Mark Bielstein. Just a couple of things and starting with an overall observation that I think your thoughts and work in this area is very difficult because I believe one of the most critical issues about the standard setting process at this point is how the FASB is going to interact with the IASB if there is some kind of move towards IFRS here in the US. Obviously you have a timing problem with that, but it seems to me if there is something that heads down that direction, determining the FASB's role in that and how it works both in the interim and once you get there seems to me to override all these other issues to some extent.

As Linda indicated, the field testing I think is critical. We've seen in recent years whether you go back to Interpretation 46 and 46R, Statement 150, Statement 157, a number of areas where shortly after issuance of a fairly major standard there has been significant changes to it that needed to be made. Those changes were good and it's good that those actions were taken, but it would have been helpful to try and identify some of that earlier on, and it seems to me field testing might be one way to accomplish that. You're never going to find all of the quirks in it but more field testing should be helpful in that regard.

As a separate area, I believe the role of the Emerging Issues Task Force needs to be reevaluated and not just because of the body, but the EITF was originally set up to try and address interpretation issues in a timely manner. With the additional due process procedures that have been added to that process which they were added for a reason and potentially good to do that, the EITF cannot address things in a timely manner like it once could. And so, either the role of the EITF needs to be reevaluated or reconstructed to be able to do that, or there needs to be some other mechanism to try and provide, even if it's not authoritative, guidance in a timely manner.

And then, the fourth observation which may not come to be a surprise to this group is that I would probably not fully support some of your observations about the non-authoritative guidance that may be issued by accounting firms and others. I think the issue is if that guidance is good guidance which obviously the issuers of that guidance think it is, then we would do it. That is helpful to people in trying to apply the standards in specific circumstances.

MR. SIDWELL: Thanks, Mark. Kevin?

MR. CONN: Yes, Kevin Conn with MFS. I actually don't have a lot of energy around many of these issues or strong points of view other than to say that it's gratifying to be an investor and be invited to participate. The leanings in the Committee to invite more investors to come and speak I think would be a terrific thing.

I think as I read through some of the things, we are not accounting experts. We don't have the time, oftentimes, to become experts at each specific accounting discipline. So, I think it's important for the Committee to understand sort of how really users use the information, what's important, what's not important. And I think that's in the proposal as it stands right now.

MR. SIDWELL: Great, Kevin, thank you. Jeff?

MR. MAHONEY: Jeff Mahoney. Just to pile upon Kevin's comments and some of the other earlier comments, I like your language around the preeminence of investors and users in standard setting. I think that's very important. There has been clearly an imbalance in the input to the standard setting process historically, dominated by the Big Four firms and large companies mainly. I think we can all agree that investors are the main customers of financial reports. And as the main customers, I think they should be more involved in the development of the product.

That said, I think John Stewart and many others have been actively involved, and we have a great set of accounting standards because of their hard work and expertise. But I think we have to get users more involved. Linda commented that there may not be a lot of users that have accounting expertise. I think that's probably true and I think we need to develop that over time somehow. The FASB has a number of user groups. I'm involved in one. I think over time there will be more users who have the accounting expertise to actively participate and benefit the standard setting process.

As a former FASB staffer, I have to disagree with Linda's comments on comment letters. I think the FASB by and large does an outstanding job on their analysis of the comment letters and considering those comments and making changes to the proposals based on those comments. I think you can compare the FASB to others, I won't name any names, but I think as far as reviewing comment letters and making changes to proposals, I think the FASB does a pretty good job in that.

Field testing, I certainly support field testing. I think the problem with field testing historically is that the FASB has had problems getting anyone interested in doing a field test. They take a lot of time and it's very difficult to get anyone to do it. I think to the extent they can get people to do it, it's very helpful. But I don't think I would suggest that the FASB hasn't been trying to do field tests. I think they do, it's just that they haven't been able to get people who are willing to volunteer to do those tests. And I don't know how to correct that problem but I think it's been a problem of volunteers, not a problem that they don't want to do it.

As far as cost benefit analysis, I don't think, and this was in my letter, I really don't think we should put a greater emphasis on cost benefit analysis. I think the FASB does a pretty decent job in soliciting from companies and auditors the cost of implementing standards and then taking that information and trying to make a judgment about how the standard should be modified based on those costs. But really, as I said in my letter, that analysis really had been kind of a cost-cost analysis. I mean, how can we reduce the cost of implementing the standard and still get an approved reporting as a result?

We don't really have what is a cost benefit analysis. And until we have a way to do that for accounting standards, I really wouldn't further emphasize cost benefit analysis. I think the cost benefit analysis should be a focus on what is the cost to investors and what is the benefit to investors. That should be the main focus since, as I said earlier, they are the main customers of the product we're producing. Thank you.

MR. SIDWELL: Thank you. Ben?

MR. NEUHAUSEN: Ben Neuhausen. I'd like to focus on two areas. One, non-authoritative guidance, and the other, the standard setting process. With respect to non-authoritative guidance, I think the Subcommittee recommendations seem to imply that non-authoritative guidance is a problem and that it is a driver of complexity, and therefore, it would be desirable to deliberately try to reduce non-authoritative guidance.

By contrast, I think that non-authoritative guidance is a symptom of complexity in the authoritative standards, that it arises because preparers and practitioners want additional guidance because they find the authoritative standards very hard to read, very hard to understand, very hard to apply. And they want the non-authoritative guidance to help them apply the authoritative standards. And so, I think if there is a problem with non-authoritative guidance, the solution lies in simplifying the authoritative standards, not in trying to reduce the number of people who are issuing non-authoritative guidance.

With respect to the standard setting process, I think there is room for improvement. I think the Committee recommendations to do more field testing, have user pre-reviews are both good ideas. And I also agree with Linda Bergen's observations that I think the FASB's use of the comment letters could be better.

We cited in our comment letter a number of cases where the FASB has significantly revised or deferred provisions in newly issued standards. And we think in many of those cases, those issues were raised in the comment letters. It's just that somehow the importance of the comment or significance of the issue wasn't recognized before the final standard was issued and only became clear after the final standard was out, and that somehow a better process of analyzing the comment letters would have picked up some of those issues on a more timely basis.

MR. SIDWELL: John?

MR. STEWART: This is John Stewart. Mark mentioned the international thing and that does bring a whole new ball game to this and the FASB's meeting with the IASB in late April on the MOU and kind of their strategy. Really maybe you guys will have to think about how that impacts your recommendations.

Second, I agree with the emphasis on the user. They are the customer, I said that this morning multiple times. I firmly believe that that's why we exist, to help those people. But I'm not a hundred percent sure what the best way to get that input is. They ought to absolutely have input.

Now, let me, maybe this is a bad analogy and I'm sure people will climb on me if it is a bad analogy. Let me try it out; I borrowed this actually from Amy Ripepi, one of my partners. She describes a situation where we're building in the bay area a new bridge across whatever they have out there. And so, we talk to customers --

MR. GRUNDFEST: It's called the bay.

MR. STEWART: Thank you. You're out there, right?

MR. GRUNDFEST: Yes.

MR. STEWART: Good. So, we're building a new bridge. And we talk to consumers about what they need, you know, they need the bridge to be here, and this is the level of activity, they need how many lanes or whatever. But when we get around to building the bridge, the consumers are not part of the group that's building the bridge. That's the civil engineers.

So, it seems to me that we ought to have accountants set accounting standards. And consumers are the users who use the information, but I don't think they’ve got necessarily the skills, and I don't mean that in a demeaning way. They don't have the background, if you will, to do the actual accounting standard writing. Anyway, think about it. That's my reaction.

The FAF changes, I agree with Amy, the FAF changes, I'm confused about what their purpose was. I don't happen to agree with them and they never articulated that I have seen why they made these changes going to five people and lodging all this power in good old Bob over here. Nothing, I like Bob a lot, but no one is smart enough in my opinion to be the sole determinant of what issues get added or subtracted from the agenda. So, I don't happen to agree with that. I know that's going to happen to the EITF as well. But why they did it, maybe I'd be more upbeat about it if I understood why, they identify why they lodged this power in my friend Bob.

Field testing, I think the FASB could do better on field testing simply by applying their proposals to EITF issues. I mean, we have them since 1984, just hundreds and hundreds of very practical issues. They don't have to go outside their building. They could take their proposals like on revenue recognition and see if it answers the EITF issues. They wouldn't even have to go, and I think Jeff is right, it's hard to get people to participate. I think he made that point. But you don't have to.

I think the FASB does a weak job in doing that and then later implementing or describing what the impact is on the EITF issues. Take FIN 46R, they just kind of almost added half of the EITF issues. Oh, you better read FIN 46R without giving people more help. So, I think on revenue recognition, I'm repeating myself, they can analyze those issues and see if it actually helps answer the questions in a better way.

I think there is a problem sometimes with the several do-overs that we've had that had been mentioned by several people along the line here where I think the FASB could have done a little bit more homework on how operational their proposal was. As I mentioned this morning, if you can't do it, if the preparers can't do it, it's really bad because it's not going to help anybody -- the users, the auditors, anybody.

I think, and last, I think standard setting is, as I mentioned this morning, an artful blend of principles and rules and people. And the key to a good standard setting process is not only the process itself, exposure drafts and all that, it's very important that the right people with the right attitudes get picked to do it.

MR. SIDWELL: Lynn?

MR. TURNER: Thank you. Lynn Turner. As usual, let me just follow up by saying I do agree with what John says on the FAF things. However, I don't agree with him on who should be writing these rules. I think as the Committee has talked about in the report, there is need for much more investor participation, and I think it should be in the form of involving participation, not just advisory boards and moving from one out of seven to one out of five. It doesn't equate to more -- one is one. And if you're really serious about additional investor representation, I think you'll change that number one to a higher number. And I think if a serious effort is made to go get the people, you will be able to turn around and find the people.

So, I just note that, in fact, as I look around the table here, there's many of us, current and former regulators, current and former standard setters, people out of the national offices, we have all been involved with the standard setting process and we have all been ones that have come up with the standards that we're all now criticizing. So, I don't know but what we've met the enemy and it's those of us around the table here. So, I certainly hope you'll continue to get the input from additional investors because we have not done a good job as an accounting profession and I think you'd have to give us a fairly poor grade if you would in what we've come up with. Although it's still all in all a pretty darn good product compared to what's happened elsewhere.

I agree, I think you've made some good points about the standards needing to be more understandable. I do think the standards should have the objectives laid out right up front. I mean, it should just say, paragraph 1, here is the scope, paragraph 2, here is the objectives that we're trying to get to. And I think that would be very helpful.

I think there was talk about cost versus benefit. If I apply the cost benefit test that you've got in the document though, we would have never seen the statement on retiree healthcare cost issued. And that has perhaps been the most important standard that has ever come out of the FASB so I'd ask you to go back and take a look at that because I think your cost benefit standard is not a cost benefit standard. It reads like it's a cost standard and we'll worry about the benefits later on and certainly OPAFS -- ever come out under that standard.

On the complexity type stuff and trying to get that out of the standards, we just have to keep in mind that we do billions of transactions in business today and it's not just financial instruments, it’s affiliations, it’s partnership agreements, it’s marketing agreements. And I don't know that you're ever going to make the accounting for those simple. We by necessity in the business side create tough complex transactions, and sometimes you just can't boil it down to simple financial reporting. And that's where the analysts come in and I think the analysts on a whole do a good job of being able to cipher through that if you've got good disclosure. I think this ITAC letter, too, you mentioned, I think there just has to be improved disclosure here around things like judgments and key assumptions so the people can get better clarity about that and better understanding.

In terms of the complexity though, and Mark mentioned it earlier, the EITF's role, I think the EITF, if you'll look at red books today, the red books today are actually now thicker than what the actual standard books are. And yet there is not a single word in your report about the EITF. There is no one that has created complexity in financial reporting in the US like the EITF. John just mentioned the hundreds and hundreds, I'm sure it's thousands and thousands of issues. I'd recommend that once and for all you put the EITF to bed and out to pasture. As long as you leave the EITF in place, you will not change complexity. You will not reduce complexity. And you will not reduce the myriad of rules. So, I'd strongly urge you to get rid of the EITF.

And with that though, I do think there is one thing that needs to be done. And that is I think there needs to be a catch-all rule. With all the business transactions we do, I don't think anyone can expect the FASB to write a rule for every type of new transaction, and they just can't keep up with it. I mean, you do due process, you ask everyone to do due process here. There needs to be in those types of situations a catch-all rule though that turns around and says if the FASB hasn't done a rule on something but there is very material information out there, then that information regardless of whether or not a rule exists needs to be disclosed to investors. We don't have that today.

So, we get new types of transactions. And you say, well, the SEC is not supposed to tell anyone about it or take a position on it. What are they supposed to do? That's their rule as a regulator. You're telling the FASB go do it and go through all this due process, it will be three, four, five years before they can ever get to it. And in that intervening time period, what are we as investors supposed to do? Avoid the disclosure and the information on it? Not have good accounting?

And I think that's a system that you've got to think about whether or not in fact you're asking to get established. And I'd certainly recommend that you think about whether or not you need the catch-all rule that says if there isn't a rule out there but there's material information to investors, that information still needs to be disclosed and put out there. And I think that would be most helpful.

And finally, I just, I think you've got to have strong SEC enforcement. I think when there's a lack of regulation, you pay a severe price in the markets. Investors pay a severe price in the market. And I think with companies constantly coming to the SEC and asking them for their opinion, the SEC staff can't just sit there and say we're not going to give you an answer. And if they see situations developing, I remember on the SPE issue in the late 80's, that issue started to develop, the Chief Accountant then at the time started to speak to those of us in the profession and tell us these are problematic, you need to start thinking about what that is. The SEC Chief Accountant needs to be in a position to do that, to turn around and protect the investors. And that needs to carry some weight with it given how quick these transactions can come up.

And I remember after he started doing that in the mid 80's to late 80's, then one of the big accounting firms, the head of their national office wrote to the SEC in the summer of '90 saying I agree with you but I've got other firms that are allowing this to happen, and therefore, you've got to go deal with it or I'm going to allow it to happen. And given that it takes time to deal with those, you've got to let the SEC be able to step into those and do what they've got to do to protect the investors or you're going to have problems in the system. So, I'll end at that.

MR. SIDWELL: Thank you, Lynn. What we'll do now is go thematically across some of the issues that you've raised. We obviously spent a lot of time as a Committee talking about the whole question of investor involvement, and obviously some of that is how to define an investor. And we spent a fair amount of time trying to focus on that. Some of the comment letters we've received have asked us to do more on that and we I think appreciate any views you have.

The second thing that has come up in the commentary, and we spent a lot of time discussing it, is this practical aspect that John has raised about how do we actually get people to get involved. So, we've noticed a real improvement that the FASB has made in terms of setting up user advisory groups of various constituents. And obviously a lot of what we're suggesting is predicated by people who are really willing to participate throughout the process of setting a standard and really help identify is this going to make things better.

So, it would be great if we could hear from you, and maybe start with you, Jeff, on how you think about how we move forward on this whole question of investor involvement.

MR. MAHONEY: Jeff Mahoney. As I indicated in my earlier comments, I agree with John and others that as far as the FASB board goes, we need investors who are experts in accounting. And I don't think there's a big pool of those or, to the extent they exist, those people are particularly interested in sitting on the FASB. So, as you said, the question is how do we find those people, how do we identify those people, how do we develop those people?

And as I indicated earlier, I think one way to do that is what Chairman Herz and Don Young and others at the FASB has tried to do is to set up more groups where they identify investors and bring them in and get them involved in the process that way. I think that's made a significant improvement as it is, just having individual groups focused on the investor community participate in the process. The FASB, because of that, receives much more input from the investor community than they did previously which was very little at all. And you know, John's analogy about the bridge, I think in many cases the investors said, the customers said don't build the bridge and the FASB went ahead and spent ten years building the bridge. And I think we have to avoid that going forward.

MR. SIDWELL: Scott, do you have --

MR. EVANS: Yes. I wanted to follow up on the bridge analogy which I think is terrific for the situation that we have. And in our recommendations, there are investors participating in several levels of activity regarding this bridge, from the governance to the people that are charged with building the bridge to the FAF to the actual engineers that are out there putting the thing up and designing it to the groups of people as Jeff referred to that are actually going to use the bridge.

And the new thing that we have suggested in addition to this more participation, more members of the FASB who are users, more members of the FAF who are users is an official user committee to do a pre-review. And it's a group of users who are going to sit down and look at the design for the bridge and talk about whether and how they'll use the bridge. They may say, you know, about the new bay bridge, we don't need it, we take the barge, it's cheaper. We're not going to use this bridge. Or it doesn't have enough lanes, I'll never get across in rush hour traffic.

Back to Linda's point, and you heard from Kevin, the user is not necessarily focused on the intricacies of design. He or she is focused on whether the thing is useful. And we design the bridge and we design the accounting standard for the user. So, one of my questions is whether this formalization of the user input is a good development and whether it will actually give investor users the power to speak about the usefulness of the design of the standards or whether we've gotten some comment letters that it's just another cog in the wheel that's just going to delay the process of bringing out new standards.

MR. STEWART: I don't feel, John Stewart, knowledgeable enough about how the users bring their needs, so I'm going to let Jeff or others respond. I agree with, it seems like they're getting more input than they have before and I think that's incredibly important. I guess I also, my intuition says that users are not a monolith, that they all don't say exactly the same thing, so that's part of the FASB's job is to weigh the different input they get. Just like we accountants think differently about accounting standards, I'm sure the users are not, as I have indicated and the survey has indicated, that they're not all on the same page. And that's what makes the standard setting jobs hard. But I don't know about, to answer your question, whether your new proposal will help or not.

MR. SIDWELL: Jeff or Lynn?

MR. TURNER: A couple of thoughts. I think you pose a very valid and very good question. First of all, let me give kudos to Bob Herz because Herz and Don Young have brought up and started up the ITAC, and I think the ITAC goes a long ways as I read through your report. What you're asking for I think has already been done to some degree by the ITAC and in fact even on the agenda setting, I think you really sit and know how it operates, the FASAC does a lot of that. But Bob probably even gets more input from the 12 of us on the ITAC than he'd probably care to have to listen to, maybe anyone would have to listen to.

But anyway, so I think he's done that. But to get more involvement, a lot of these shops don't have someone that focuses just on accounting type issues. For example, at Colorado -- where I'm at, we've got a $43 billion fund. We don't have an accounting analyst. We've got portfolio managers that manage specific portfolios and their CFA's so they very well know it. But would I say that they are per se an accounting expert? No. But some of the shops do.

Capital Group which is the largest active fund manager in the United States has people and they are very good and Bob has got them involved. CalPERS now has dedicated to it. Jeff, and the Council for Institutional Investors, has set up now an informal working group to try to develop more of these. That's occurred in probably just the last four or five months. So, there are efforts underway.

As that effort develops so, I think you've got to turn around and make it very clear to investors that their voice is relevant. If you're only one out of seven people on a board, you've got to ask yourself why go there and why go do it, especially if you take a pay cut. And I think you have to, one, increase them, make them relevant, increase their voting significantly. And the second thing you've got to be willing to do then is pay them to get there. People aren't going to take a 50 percent pay cut to go do this stuff and so you've got to be willing to pay them commensurate with what they are worth.

MR. EVANS: If I could have a follow up? I completely agree with you that for the members of the FASB who might be investors that you need a certain degree of accounting expertise. It goes without saying. But for the user group that would be doing pre-review, wouldn't you actually be better off with just standard users -- portfolio managers, analysts, serious retail investors who would look at this and say “This works. I'm going to have enough lanes to get across the bridge and the toll is right and I'll have everything I need,” because that's who we're designing the standards for?

MR. TURNER: I'm not sure I would totally agree with you, Scott. The ITAC does do, just so you know, Bob and his group does bring to us where they're developing new standards, so like redoing the SPE stuff, he's brought to us a number of the issues, some of them nicely outlined and are not bad earlier this week. And so, he has brought that stuff to us and they have actually asked us for input.

So, when you talk about pre-reviews, that's already occurring. And I can tell you, we're providing again a ton of impact or comments on that already. And there are 12 in that group. There's credit rating agencies, there's analysts at the Wall Street firms, there's financial analysts that provide research to many, many institutions.

But there are, I've got to tell you, especially in my days at Glass Lewis, I visited with hundreds of investors and many, many portfolio managers. And some are very good and some are not very good. It's just like with any business. And especially when you get into areas like the indexing and all, you know, those, I'm not going to go get a portfolio manager to do this who is involved with an index fund because they aren't into this as much as they are into their indexing.

So, I think in general, just to say portfolio managers doesn't get it done. It's specific people who fill that role and really understand. The person at Cap Group, for example, when she gets involved and there are issues that come up like with the SPE, she turns around and surveys all of her portfolio managers. She really understands it. She puts the question to all the portfolio managers, then gathers that survey information back in and takes that and then feeds that on to Bob or the group.

And I've seen Jeff and his group do some outstanding work in this same way. Jeff goes out and once a month sends out questions to the CFA people, asks them for input on specific issues, gathers it and then that information is provided on to whoever is asking for it, the FASB or whoever. So, the users have processes in place to get you the data and it can be done. I'm not sure if people always listen to the data on a number of the, quite frankly, on a number of the standards.

If you look at pensions, you look at OPAFS, you look at derivative disclosures, when those standards, even 140, when those standards were all initially developed, there were user comment letters that said you've got problems in these and we need additional disclosures. And yet those requests were ignored and we never got the disclosures until one, two decades later. I mean, what Bob just put out on derivatives which is tremendous and a tremendous improvement is what investors asked for back when 133 was originally proposed.

And that's why I think one of the key things that's really great in your report and I give you kudos for is that you're saying let's make the investor preeminent. So, when you create the mission statement for the FASB, it says first and foremost the investor is preeminent, and I think what's good for them will be good for those of us who have been in business, then I think that will cause them to look more closely at the comment letters and you'll get some of these things done on the first round rather than the second or third.

MR. EVANS: So, would you agree then that the more that we could formalize the investor review process which as you describe is already pretty well along to make it more public, to give it more publicity and weight in the standard setting process the better? It would facilitate the objectives that you currently have on ITAC and the other user inputs and assure that preeminence to a greater extent.

MR. TURNER: Yes, I think to the extent you can formalize a preeminence, that's helpful. Again, I'll say at this point in time, I think those of us in ITAC, and I'll let Jeff chime in here on his own, I think we feel that the board doesn't always agree with us but I think the board does listen to us. And I think the FASB staff does listen to us. So, you can formalize whatever, but I think that has already been accomplished and is working pretty well.

MR. SIDWELL: I know, Joe, you have a comment.

MR. GRUNDFEST: Yes, a couple of questions actually. You know, part of the conversation here, one way or another, circles around the idea of information flows and whether we have information failure. Just, you know, first, you don't have to have accountants on staff in order for you to be able to get the information you need if you think that there is an accounting issue, all right. There are all sorts of consulting firms you can go to and you can rent the expertise and buy the reports and have other people look into them. I won't advertise by mentioning some of them but everybody really knows who they are, okay.

So, the fact that some organizations have accountants on staff and others don't is certainly true, but I'm not sure what is proves. Second, if the general perception is that this additional accounting information in terms of interpreting it has value, well, then it would seem that it's rational for portfolio managers to go out and to buy this expertise, hire people in or what have you. So, is there a market failure here? Is it that accountants are able to add more value that generates more alpha, and because they are accountants they're discriminated against and they're not appreciated and they're not --

CHAIRMAN POZEN: That's a new category.

MR. GRUNDFEST: No. I mean an insular minority worthy of constitutional protection, I suppose. So, one question revolves around the idea of are we talking about a potential market failure? And if we are, what is it and how does it work?

Second, if we look at our society at any one function market, there are many important markets in which people rely on third parties to interpret complex information. Medicine, okay, prescription drugs in particular, we don't let people make decisions about which prescription drugs to take, all right. You have to have a trained person, a physician to provide a prescription for you. In the law, a person who represents himself, has a client for a fool, all right. You can run down all sorts of areas where information intermediaries arise naturally, and in some situations are put in place by the law.

So, the question then is there is an inherent amount of complexity and difficulty in understanding this stuff, and isn't it also optimal that society rely on information intermediaries? Because otherwise, everybody who wants to buy a stock in the United States has to be presumed to have something like a CPA degree. It becomes a very difficult equation that way.

MR. TURNER: Joe, first of all, let me come back and say I'd rephrase it, is there a market value, I'd rephrase it, is there inefficiencies in the market. And I'd only point to the sub-prime problem to say not only are there inefficiencies --

MR. GRUNDFEST: I agree.

MR. TURNER: But in the short run, there can be tremendous and great inefficiencies. And the information --

MR. GRUNDFEST: I agree. But let me tell you where I think that example goes. That example goes to making sure that you get the appropriate information out to the knowledgeable people in the market who can then further disseminate it appropriately. And the real information failures I think occur, and we can use the medical analogies as well, when you don't get the appropriate information out to the docs in a way that allows them intelligently to prescribe, that's a real failure. When you don't have the appropriate information about sub-prime and what the risks really are and how all of this stacks up under a variety of scenarios, that's a real failure. So, we're in total agreement on that level.

MR. TURNER: Yes, and I think that's why I came back to the point and made two points on the disclosures about judgments, there needs to be a lot more because that information has clearly not gotten out there. And you've got to have the catch-all because you can't expect the FASB to write a new standard for every new thing coming down the road. And I know some of the firms have written comment letters recently on the business judgment thing urging much more disclosure, and I couldn't support them more on that.

And I think it runs to this very problem of information is the lifeblood of the markets.

If you don't have the appropriate information in the markets, they will be inefficient and maybe highly inefficient, as we've recently seen, in the short run. And the short run is not necessarily just a quarter or two. It can be an extended period of time until the information comes out, gets analyzed and there is enough participants in the market that re-price the market. Now, there will be some investors that -- quite frankly not all portfolio managers are equally smart.

And so, you are going to have some bad pricing that isn't inefficiency, just bad pricing on the part of investors. And there is nothing we can do to, when people make stupid decisions when they had all the information, we can't help them out. The market in the end though will take them out of the market.

But what we can do is for those who can make informed decisions and then just adjust the pricing because they're smarter, we can get them the information. And right now, we are getting them the information. Bob wrote an Op-Ed earlier this week on the 140 stuff that for the most part, not entirely Bob, but for the most part I thought was pretty good and he talked about the information that we need. We just didn't get that out there. And yet we, you know, someone should have known. And some very small participants in terms of numbers did realize it and act on it.

CHAIRMAN POZEN: One of the problems we have is just a focus issue as investors because analysts look very broadly at a lot of things and it's not clear until quite late in the game that this accounting issue is really important. So, it's hard for analysts to get worked up if you have a big shop like capital research work and that they can have somebody who specializes in that, well, that's a great step. And Joe is right, you can hire third parties to do accounting and many people do. But you've got to first decide that that's an issue worth focusing on. And people like Kevin Conn who are in the banking area, that's what they do, so they're focused on it because of these issues.

But in other areas, it takes a while. And I have to say I have sympathy for Bob Herz about the difficulty of getting the investing community to really put the resources into these accounting committees. It's the minority of us rather than the majority of us who do it.

MR. SIDWELL: Jim, you had a question?

MR. QUIGLEY: I just wanted to ask Kevin and Jeff also, both of you made the comments as you were going through your preliminary thoughts that you "were not accounting experts or investors," "We're not accounting experts or investors, don't have the time to become accounting experts." Is it possible for us to get the voice of the investor in the process short of having investors on the FASB itself and through advisory committees or through ITAC? Can that notion of preeminence be accomplished and can we actually have the right expertise we need for board members that have, that in fact are investors in the way that we have defined them?

MR. CONN: Yes, this is Kevin Conn with MFS. Yes, I don't know if they should be on committees or exactly what role they should have. The points of views I think need to be shared and be part of the dialogue, absolutely. And I would suggest usefulness to Scott's question, the usefulness of the information to allocate capital versus conceptual precision or some balance of the two. I mean, you don't want something that is conceptually incorrect obviously, but you also want something that's useful.

And so, and maybe the criteria is, is this useful for investors to allocate dollars to different investments. You know, just balance that criteria with the criteria of we want to have the exact right way to think about things. So, I don't know if they need to be on committees or not. That's for you guys to decide. But to have some input to the dialogue is, one, appreciated, and two, I think will make it more productive because, you know --

MR. QUIGLEY: I was just trying to really clarify and understand your thinking on that. With respect to the recommendation of the investor as preeminent in the process, we in our thinking have felt that meant representation on the governance, that meant representation on the board, actual FASB members. And as I've listened to you, I've just tried to understand, do you believe that the investor voice could be preeminent in a process something short of being board members with pre-implementation reviews or very active participation on these advisory committees where that becomes a loud voice in the standard setting process but it is short of a board member?

MR. MAHONEY: This is Jeff. I would support having investors involved in the entire process, having them on advisory groups, having them on the board, having them involved in the governance of the foundation. But I understand that it may be difficult, particularly on the board level, it may be very difficult to find the accounting expertise and the willingness of the individuals who have that expertise to sit on the board. So, that's I think the more difficult one.

But as far as the advisory groups and in the governance, the foundation if there remains a foundation, I think there is no reason why we can't get more investors involved in both of those right away. I think Bob, Chairman Herz has already done that with ITAC, the user advisory group and investor task force as far as committees, but I think if we're going to keep the Financial Accounting Foundation, I think we need to get more users involved there.

And then over time, I think we can identify and develop people with the sufficient accounting expertise to participate on the board. And I think once we identify those people and there is a group of them that we can access, then we should seek to increase the level of investors on the board itself.

MR. CONN: Yes, I would second that, Jim. I would agree. This is Kevin Conn with MFS. I agree with Jeff that investors should be a strong voice in terms of being on committees. My hesitancy before is just because I'm not familiar with how the process works, so I didn't know if they could have some voice, how impactful a survey is. But I do think they should be there to vote on things and to bring the usefulness criteria to the dialogue as well as the conceptual in the exactly correct framework.

MR. DIERMEIER: Jim, if I could mention, make a comment there. To the degree that my membership who have read what we put out and I think interpret it in a proper way, they have assumed that there would be complete involvement all the way through the process on governing boards. If for some reason we thought some pre-review panel would somehow satisfy that, we need to be very clear about that. And I can assure you that we will hear very loudly and clearly from them because those members believe that we've tried the other approach for a long time.

MR. SIDWELL: Thank you. Ed?

MR. NUSBAUM: Thank you, Dave. I'd just like to dig a little deeper on the user perspective. Jeff, you mentioned that the cost and benefit should be measured from the perspective of the user. And I absolutely agree. I just, where I'm struggling is sort of how you do that. What's the process? And what should we, you know, the standard setting process, how does that, what is the effective way, other than just asking?

Obviously we've been talking about putting people on committees, that's very helpful, and asking people what they think. But sometimes when you just ask, you know, if you just ask somebody, 50 years ago did they need a personal computer, they'd say no. And you think about the conversation with fair value this morning, how would people really use fair value information? What would be the benefit? What would be the cost to the user?

And so, do you have any thoughts on the process for getting us there?

MR. MAHONEY: Jeff Mahoney. That's the problem really is how do you do it. And I've looked at this a little bit and no one has come up with the solution yet. And so, my comment is until we do come up with that solution, we shouldn't put a greater emphasis on this cost analysis because I think that just adds more layers to the process, extends the standard setting process even further if that's possible. And I think at the end of the day, you end up with a product that often isn't what investors would want.

So, I don't have the answer to that question. I think a lot of people have looked at that and still have not come up with anything yet. I think we need people to continue to research that issue and try to come up with a way that we can truly do a cost benefit analysis from a user perspective.

MS. BIES: Dave?

MR. SIDWELL: Thank you. Susan?

MS. BIES: Let me just sort of follow up on this line of thought because from two perspectives, one is that as you were mentioning from the user's perspective, larger shops tend to have in-house accounting experts that they can rely on that the smaller don't. The same thing for preparers, the small companies don't have in-house experts on things. And whether there should be either a phased-in period that smaller organizations would have a longer time, I'm talking about preparers now, they don't have as big of an investor base. They tend to be more closely held. But the fact that if something has to be redone, they wouldn't have to do it then again and they could learn.

So, would you be in favor of some kind of, from a cost perspective, allowing small to mid-size companies a little longer to implement? Is that something that is a possibility in looking at some kind of a cost benefit where the preparer cost could be high for a certain group?

MR. MAHONEY: Jeff Mahoney. I certainly support giving smaller companies more time to adopt a standard and learn from the larger companies initially. I think the FASB has done that on a number of occasions and I think that's been appropriate. I think there is a difficulty in defining what is small, that's the issue. But to the extent that you can get over that and that's not easy to get over, but to the extent you can, I personally would be fully supportive of giving them more time, letting them use the experience of the larger companies before they have to actually implement.

I think that's a good idea. The FASB has done it a number of times in the past. I think they should continue to consider doing that on projects going forward.

MR. SIDWELL: Can I just draw this bit to a close? Because I think it's been very useful to us to really focus on your views on investor involvement and that scenario, that obviously we have got very central to what we are trying to develop. I would like to cover a few other areas as well.

One of the topics in the areas of standard setting process that we've given some additional thought to in discussions with Bob Herz and also in response to many of the comment letters that had been written which is we had in the original report talked about an agenda advisory group. And as you can see from the status report we'd put out, we're thinking of changing the name of that to be much more of a financial reporting working group concept because as we had originally framed this, we thought it would be very useful to the process that given how important it is to any reporting system to be clear about what is it that's on the agenda, you're trying to deal with it, who is actually dealing with the current issue of what time frame with what other groups participating. We felt there would be real benefits if there was a group that was pulled together that was in our current term really focused on all of the issues in financial reporting.

So, we were thinking that this would involve, besides Bob as chair of the FASB and obviously onto the FAF changes having responsibility for the agenda but including many other groups at the senior level, whether it's the SEC, whether it's PCAOB, users, to really help identify what are the big issues, who should be dealing with those issues and how is that going to get done. None of you raised this as an issue this morning. Many of the comment letters focused on is this an overlap with FASAC, how do we really get this to work effectively. Any views on that? Because I must admit a couple of points this morning pointed that probably this area of agenda setting is a very important area for us to make sure we're focused on. Dennon Locke or somebody I haven't heard from in a while have any views to get us going?

MR. BIELSTEIN: This is Mark Bielstein. You know, to some extent, and I'm not sure exactly how far you're suggesting you take this advisory group, but I mentioned earlier the EITF. One of the original goals of the EITF was to address those kinds of emerging issues. Now, that group was actually intended to solve the issues. I think here you're just trying to get them identified.

I think that's an okay process. My expectation is, through whatever mechanism, the FASB is becoming aware of the issues that need to be addressed in a relatively timely manner. Now, whether that's through FASAC, through EITF topic submissions, through their just informal process with the SEC and discussions with accounting firms and preparers and the investors task force, my expectation is there aren't many real big, major issues that they're not finding out about. But having a group like this that would formalize that process might help particularly in the new agenda decision process.

MR. SIDWELL: I think we were also, in doing this, focused on it wouldn't just deal with those issues that the

FASB might deal with. It could deal with areas that others involved in the financial reporting community might also be engaged in giving a guidance on.

MS. BERGEN: So, are you saying, David, that you would allocate the work that this agenda committee decides needs to be done among FASB, the SEC, the PCAOB? Is that what you're suggesting?

MR. SIDWELL: Well, I think we, to use an example, some of the guidance that has come out of the audit quality group of the large firms, we were thinking this is a good forum before any guidance is given by any of those senior groups, that it's a good forum to say what is the issue, who should deal with the issue, is the solution that is being identified on this issue something that everyone engaged in the financial reporting process is comfortable with? So, something very real time, just making sure that if the FASB feels it has a strong view, that it should jump in and be the leader of providing that guidance, that the opportunity is there.

And I think we would agree with what Mark had said, that, Sonia and I had discussions with many participants, that there is a very much strong but informal network working today. We were trying to see some formalization of that process.

MR. TURNER: But David, here is the concern I have with it. What I really don't understand about this agenda committee, and first of all, I think it's preeminent and very important that the FASB maintain their independence and other people don't dictate to them what their agenda is. I think if someone should dictate their agenda to them from time to time, it probably should be the SEC in the role of protecting investors. That's one place where I'd probably draw a line.

But you and I have both sat on FASAC, I think even together at times, and when I look at what you just described and what you're talking about, it's what we all did on FASAC. We talked about issues. We even did the annual survey. People filled it out. And we turned around and said here's what the issues are and what needs to be addressed.

I've never seen a FASB chairman and board members who didn't know what the issues were and what needed to be addressed. Then it became an issue of do they have the resources to go do it within the context of what they have to do from due process. So, I'm not exactly sure really what you're trying to achieve here and what your stated point is really what you're achieving. I think the vehicle is already there and it seems to me we're just heaping bureaucracy here on top of bureaucracy. You're going to add another component at a cost to the FASB where those resources could perhaps better be spent on staff or other areas.

I just, you know, I've sat around that FASAC table and what you just described is exactly what we turned around and did. And to add another layer on top, I just don't know that I see the bang for the buck.

MR. SIDWELL: Ben and then --

MR. OLSON: David, this is Mark Olson --

MR. NEUHAUSEN: This is Ben Neuhausen. You know, I have not been on FASAC but I have always read the FASAC materials. In my sense of the FASAC agenda discussions and your agenda survey is that it was largely reactive. It was setting priorities for the issues that the FASB had already identified that were either on the agenda or were potential agenda items, but that FASAC was not doing, was not asked to do sort of fresh thinking about what else maybe should be on the agenda that isn't there now. And that's what I thought was the value of this new committee, what was incremental beyond what FASAC or other groups accomplish today.

MR. SIDWELL: John, do you want to go next? And then, it sounded like Mark Olson has a comment, too. So, John, after you we could hear from Mark.

MR. STEWART: Okay. I kind of agree with Lynn. It wasn't clear to me what the value added was, how this was bringing something new. I think Lynn is right, that the FASB is on top, you know, understands most of the hot topics. I wasn't sure what this group would do that wasn't happening elsewhere. And the FASAC, they do ask in the survey about new stuff, so I don't know if it gets read but they do ask about something new that the FASB ought to be working on that they aren't working on. But this seemed, you know, I couldn't, you didn't convince me yet that this was a good idea because I wasn't sure what more it was going to do that isn't already happening somewhere else.

CHAIRMAN POZEN: I think one thing it might do is take things off the agenda which doesn't seem to be a strength of the current system.

MR. STEWART: Yes, but Bob decides that all by himself. You've just got to have lunch with him or something.

MR. SIDWELL: Let's all listen very carefully and see if we can hear Mark Olson, and then Bob wanted to make a few comments. Mark, can you speak loud?

MR. OLSON: Can you hear me, David? Hello, can you hear me?

MR. SIDWELL: Barely but keep on going and try and speak loud. Mark, go --

MR. OLSON: There is a working relationship among the parties, among the FASB, the SEC and the PCAOB at the moment. But I think that that's primarily for the purpose of internal communication and for the purpose of making sure that each of us know what is on the agenda for the others. But that sounded quite different from an agenda setting group. If we were invited to participate in an agenda setting group, I think that the work product would be far different from just the communications vehicles that have been established up to this point. So, I would be encouraging about the effectiveness of a group that were directed in the way that you're suggesting.

MR. SIDWELL: Thank you. I think we all heard that, so we appreciate it. Bob, do you want to go next?

MR. HERZ: Well, I think that the thought here was, and whether it would be something FASAC-like or whatever, would be that we have FASAC, we have other groups, the PCAOB has a group, there's some overlap between that. There is the CAQ now, and of course very importantly, there are the users. But because issues often come up, some of them are issues that are much more what I'll call supply side oriented, you know, one firm doesn't agree with the other firms, doesn't agree with the SEC. Somebody thinks the auditors are interpreting something wrong, you know, forcing level 2 or level 3 would be better.

You know, those kinds of issues that come up, you get a more real time group that say these are the issues in the system. Because we, I think in our country generally, you know, we've kind of added on different groups at different points in time, the FASB, the PCAOB, SEC's got its mandate in that. But we're a little Balkanized. I think it's more, to me it's better to address things in terms of the reporting system, not just whether it should be an FASB issue or a PCAOB issue or say here's an issue, how are we going to deal with it and who is going to deal with it kind of thing.

I think you'll observe in some other countries that they have what they call financial reporting councils that are a little bit different in function but at least they get, you know, it's a more coordinated type of response to things. And I think that was kind of the view in that. I think there was also a thought that that might be important in the future if we were to go to IFRS in this country and what would be the architecture in this country for dealing with the many interpretation issues that are likely to arise and how, you know, or just application issues and all that, to deal within the whole system rather than FASB go write something, SEC put out something, that it would be just a much more holistic way of dealing with reporting issues.

And it may be that, for example, to Scott's point there, that the issue comes up and the firms disagree or the SEC, for whatever reason, and you get a bunch of users in there and they say we don't really care about this issue, but we do care about another issue that's in there that isn't kind of the constant issues that are being generated by the supply side of the equation.

MR. STEWART: Some of the things you were describing was a role that the EITF had and I was surprised to hear that Lynn would like to do away with it. He made a hand signal, I wasn't sure what that meant. But I'm surprised at that. I think the EITF has an important role to fill and take some of the pressure off these implementation issues that come up where people in good faith absolutely disagree with each other.

MR. HERZ: Yes, but the EITF generates its own work. It's like one thing begets another thing begets, and it's always --

MR. STEWART: Let me give you an example, all right? A real life example where the EITF played a role and brought the accounting firms and the SEC together so life could go on and we could be friends again. This was, you know, you prepaid for some supplies that are going to be used in an R&D project. The principle is clear. Statement 2, expense R&D. But the groups were absolutely, hundred percent divided. The SEC actually made companies restate over this. And someone needed to take that issue and resolve it. They were both arguably understandable answers. Expense immediately, expense when you use the supplies.

Okay, so how do we solve it? Did anybody care? Someone must care, it made a big difference to the income statement. So, what group is going to solve this in the future if we do away with the EITF that brought the parties together. Users were kind of represented at the EITF or getting more so, and this was an opportunity. If we do away with EITF, who is going to deal with that.

MR. HERZ: I don't, I mean, the thought would be that this group would say we think we have a real issue here. The users would say “Yes, we do care about this issue, it makes a real difference” and say “How are we going to deal with it?” Well, the way to deal with it would be we ought to have some standard setting activity. It may be then that the EITF is an appropriate vehicle for doing that, but there may be a bunch of other issues. People just say no, it's more an issue of auditing guidance. Don't put out another piece of EITF literature when it can be solved in a different way.

MR. STEWART: Okay. I'm good on that. I mean, I think the EITF, I was on EITF for a long time. I thought we knew where things, if we can do them and things we couldn't do. There were some issues that did seem like auditing related and not what we could do.

I think there needs to be a group to deal with, I know it adds to the literature and I know you guys think, some of you guys think that's bad somehow. I actually think that it's sometimes helpful to know what the answers are so that users get a consistent answer out of their constituents.

MR. SIDWELL: So, Susan, you're going to wrap up this section?

MS. BIES: Well, I just would like to say I think there is a role for the EITF. And I'll give, I've been off the EITF for over seven years but a lot of the issues when I was on it dealt with revenue recognition and we had a lot of discussions. You remember, Bob, you were sitting around the table, too, for some of these, that we kept saying we're dealing with issues that really are here because the FASB hasn't acted. Well, we still don't have a revenue recognition standard and it's been all these years, and yet users and preparers need some clarity on what to do in the interim.

And I'm very concerned if it gets wrapped in the bigger FASB broad standard setting that how do you deal with things as they quickly emerge? This world is changing so quickly. So, I'm very uncomfortable to do away with the EITF.

MR. SIDWELL: Okay. Jeff and then Mark, and then we'll move on.

MR. MAHONEY: Jeff Mahoney. Just a quick comment in response to Susan's comments. One thing that has changed since you've left is now they have FASB staff positions.

MS. BIES: I understand that but I'm just still saying.

MR. SIDWELL: Mark?

MR. BIELSTEIN: The only observation, I agree completely with what John was saying about the EITF and the usefulness of it. Under our current procedures, my concern is the EITF is not able to act as timely as it once could.

MR. SIDWELL: This is actually probably a really good lead in to one of the other areas that we've received a lot of commentary on. And I think there's some misunderstanding and we obviously need to clarify what we were trying to sense is on the whole area of what is authoritative interpretive guidance and what is non-authoritative. And Ben, you raised this point earlier on as one of your issues.

I think what we were not trying to do, to use a double negative, was to in any way stop the flow of information, flow of people's opinions on what a particular standard meant or how a particular kind of question should be answered. What we were focused on, however, and we did receive a lot of feedback on this was we need to be clear about what is authoritative and what is just implementation guidance which doesn't necessarily have an authoritative label ahead of it. So, our intention had been that for things to be authoritative predominantly it would come from the FASB. And as many of you talked about, there had been a lot of amendments to standards as part of, in a way, the formalization of implementation guidance when it's clear that an amendment to the standard needs to be made.

But we were not trying to in any way stem the question of people issuing implementation guidance. We were just trying to avoid one person's implementation guidance necessarily being more authoritative than somebody else's unless it was issued by the FASB or from the SEC with sufficient due process.

Do you have any views on this that you could share with us? Because one of the things we've heard a lot of, and particularly when we had the panel in December, was currently what happens is too much, as soon as either it comes out of the SEC or comes out of one of the audit firms, it is interpreted by everyone, this is now what we have to do. And we were trying to create much more of an ability with sufficient due process and thought on an issue that that was an acceptable alternative as long as it matched the standards of care involving the audit firms et cetera.

Any views that would help us to think further about this? Mark?

MR. BIELSTEIN: Yes. As being part of a group that provides non-authoritative guidance to our own firm and to clients in other situations, in the questions that arise when people look at that, I don't think there is any question that they realize that what we put in our interpretations is not authoritative. I mean, that's very clearly pointed out in some of those discussions.

Now, obviously when there is difference of views in non-authoritative guidance, whether it be between different organizations or whoever is putting that out, the preparers and the auditors ultimately have to make a conclusion as to whether one is more appropriate than the other, whether more than one is acceptable, and that's where appropriate judgments come into play. But I don't see a lot of confusion about what is the authoritative literature as compared to what is not authoritative.

MR. SIDWELL: Ben?

MR. NEUHAUSEN: Ben Neuhausen. I think, to a large extent, this issue of what is authoritative versus what is non-authoritative is going to be much clearer in about a year when the FASB codification goes final because that will be all the authoritative literature in one document, and then anything that is not in the codification will by definition be non-authoritative. Now, I think you are right that sometimes if guidance comes out from an accounting firm, it can sometimes be taken as authoritative. But I think that's really dependent on the quality of the analysis.

And I think sometimes some of the non-authoritative guidance from the accounting firm links the guidance so clearly to the authoritative literature that there just is no other way to interpret it, and then becomes authoritative by virtue of its intellectual strength, not just because an accounting firm put it out but because the argument is so strong. In other cases, as John was alluding, accountants in good faith could reach different interpretations, and so one firm's guidance would be non-authoritative because there is another equally good way of analyzing the authoritative literature.

MR. SIDWELL: Linda, do you have a view as a --

MS. BERGEN: Yes. As a preparer of financial statements, we certainly look to the authoritative guidance. SEC speeches, we can certainly consider them authoritative even though they may not officially be because that's what the SEC is going to be looking for when they review our financial statements. So, de facto, that kind of guidance does become authoritative.

But I don't see what's wrong with the hierarchy kind of concept that we have today with the SEC, as the chief standard setter, delegating most of the work to the FASB and the EITF, and as you move down the hierarchy, you get different levels of how good is this guidance. That seems to me to be quite reasonable.

I guess where we have trouble is when there is conflicting guidance among the Big Four firms or when like papers are written by groups we've never heard of. You know, they suddenly popped up and yet they now do certainly contribute to our understanding of what is appropriate accounting standards.

There ought to be, I guess, some official hierarchy and perhaps you're reorganizing that hierarchy. The codification, Ben, I think will be a good thing, but as I understood what I read is that a lot of the SEC literature won't be in that codification, at least not in stage 1. So, without that, it's not quite complete.

MR. SIDWELL: Thank you, Linda. Denny, you next, and then --

MR. BERESFORD: Could someone, I mean, maybe John or somebody or Jim clarify that point?

MR. KROEKER: Well, one, our speeches aren't part of the authoritative literature. They won't be included in the codification. But SEC's guidance is going to be included for ease of reference in the codification. However, the official source of SEC literature doesn't come through a codification. It comes through the Commission.

There will be pieces of staff guidance that are going to also be included while non-authoritative might be useful for people's reference, for example, staff accounting bulletins, so that would be in the codification. And I think it's already in the draft or the version that's online.

CHAIRMAN POZEN: But there was a curlicue about whether or not for some technical reason they could be formally included in codification?

MR. KROEKER: They're in there but that doesn't become the source for authoritative guidance. The FASB or the FAF isn't the publisher of authoritative guidance for the Commission.

CHAIRMAN POZEN: I see.

MR. SIDWELL: Denny, you had a question?

MR. BERESFORD: I guess I'd like to go back to a comment that Mark made at the very beginning about it's hard to stop the accounting firms from issuing their own guidance. But to both Mark and Ben in particular, with the authoritative codification sometime in the relatively near future, and other non-authoritative literature including the accounting firms, including speeches, whatever it might be, do you think it's possible that accounting firms can accept more than one approach within their own practice for some of these issues? I guess I would give John's example of expensing or not expensing the supplies in anticipation of an R&D project for example. Ben's comment about the intellectual arguments or whatever, I would assume that both sides of that particular argument felt that they had intellectually analyzed it properly and come up with different answers.

My question is are corporations then going to be bound by the accounting firms' non-authoritative guidance?

MR. BIELSTEIN: This is Mark Bielstein. Denny, I think we do that, go through that process today. And I think there are facts and circumstances where maybe our firm would put out guidance based on how we think a new standard should be applied, based on our interpretation. Another firm or another organization might put out the guidance and would look at that and we may run into situations where somebody, one of our clients would follow the other guidance. We'd look at it and say, well, in some cases that may be a reasonable interpretation and we wouldn't necessarily object to that. In other cases, we would go through that evaluation and it's possible to say, well, we appreciate this other organization came up with this guidance but in this particular case we just don't think that's right.

So, I think we go through that process today and make those determinations as to whether that's a reasonable approach based on a review and judgment of the facts and circumstances. And it will be different answers in different circumstances depending on what the issue is.

MR. BERESFORD: So, you don't think things will change very much under the codification approach?

MR. BIELSTEIN: Well, I think the codification, as Ben said, will clarify what's authoritative and non-authoritative if people are confused by that. I think the codification will be a great help in trying to find all the authoritative literature. It's a huge benefit so it will be some place that's easily accessible. I don't think it will necessarily change the judgments that we try and go through in how we address issues today.

MR. SIDWELL: Lynn, you had a couple of thoughts?

MR. TURNER: Well, I honestly think this is an issue that's been with us for as long as the profession has been around and I don't think there is any silver bullet. I remember when I was at the Commission the first time from '89 to '91, the AICPA-SEC regs committee came to us at the time because we didn't publish our speeches and harangued us and harassed us. And after I left, about the time Walter Schultz came in, then they started making the speeches, probably because the profession and everyone had come in and asked for them to turn around and be public. And the reason was people wanted the answers to a question and they wanted to know what the answers were.

And so, all of a sudden speeches started getting made public. And no sooner did speeches started getting made public than people who didn't like the answers in the speeches turned around and said don't make the speeches public anymore. And so, this thing has gone back and forth. You like the answer if it gives you the answer you like; if you don't like the answer that it gives then don't make it public or don't hold me to it.

I think the firms have done a tremendous job of putting out the information. As a CFO, I reached out and tried to get whatever information I could from Don or Ben Shaw, the UCM stuff from Mark Schopf because they would provide me information that would help me do a better job of my accounting. And I don't know why anyone would want to take that away from me.

And from time to time, to John's point about the EITF and one that would support his view is we constantly saw where three of the, or at that point in time for the five firms that go off and come up with one answer and all of a sudden one firm would come up with another answer and you'd wonder why and it seemed to be totally off the reservation. And the firms used the EITF to bring the one back on to the reservation.

So, those type of issues have come up and maybe it's why Spacek quite frankly said the only way to deal with this is just to create an accounting court on these issues, you should just take the issues to the accounting court and let them decide the issue and get on with it. But I certainly would be disappointed if someone turned around and said we don't want the accounting firms to put out their view. I mean, I want as a CFO to be able to go to my accounting firm. I want to be able to get their advice. And if they put it in writing and put it out there in a publication, more kudos to them. That's great.

And let's not, everyone understands it's not authoritative. The notion of what's authority or not, I think that's a cop out and a hoax. We all have access to a digital search system now on any of this stuff. You can quickly go search, and when you do those searches, you know, automatically what is and isn't authoritative.

So, it's anyone that can run a computer with what is now fourth grade literacy on a PC knows how to do it, can do it, so it's not that tough to figure out.

MR. BERESFORD: Lynn, I think the problem is right now it's going to be very easy to do that for the authoritative stuff, but for the non-authoritative stuff that's everything in the world. And not everybody has access to all of the accounting firms' literature, for example, or all of the other interpretations that might be around. I mean, in an ideal world, I think that would be terrific but I don't think we're quite there.

MR. McCLAMMY: And I think one place this came up was particularly for small and mid-size companies. I think it's hard enough for the large companies in the US to keep up with all of the SEC speeches and different sources of unauthoritative GAAP that's coming out. But for a small or mid-size company to keep up with it is just totally impractical. I think the thought was more not that the SEC shouldn’t be giving the kind of guidance they're giving in speeches, but it should be coming through one voice from the SEC, so you know if you look at that one source, that you have their feelings and you don't have to go all over the place searching for it.

MR. SIDWELL: Bob, and then John Stewart.

CHAIRMAN POZEN: Yes, I just want to make clear, I don't think our recommendation is in any way to stop the firms from issuing whatever learning and analysis they have. It's just to make clear to the extent it's not clear that it's not authoritative.

I think the more, and I think probably it's fair to say that at least once this codification comes out it will be pretty clear, but you do have groups like the AICPA and now the Center for Audit Quality. And when they put out things, I think that's a little less clear cut as to what their status is, whether they're speaking, then it's not the firm, it's somehow the industry. And I was wondering whether, Mark, you took the same view as to pronouncements by those sorts of organizations?

MR. BIELSTEIN: I think Ben is part of that AICPA that's --

CHAIRMAN POZEN: Okay, well, we'll have Ben answer, too.

MR. BIELSTEIN: But I can, I mean I think those kinds of, that kind of literature coming out from an organization like either the AICPA or the Center is useful because it does have a broader distribution potentially than just one firm doing something. And you know, I'm not sure there's a great deal of confusion about what's authoritative or not, but I think those organizations putting out some of that information to their members is useful and helpful.

CHAIRMAN POZEN: Well, when I ask for a memo from my audit firm on what's GAAP, AICPA things show up as GAAP.

MR. NEUHAUSEN: Ben Neuhausen. There is some confusion I think specifically with the AICPA because AICPA documents used to be authoritative. And so, certain of the audit guides, certain of the statements of position are authoritative. Accounting guidance from those documents will be in the FASB codification. But I think it will be very clear going forward with the new AICPA documents that they will say in them that they are non-authoritative.

MR. SIDWELL: John Stewart?

MR. STEWART: I would ask you just to think about the real world process and how it works when a new standard comes out. The FASB has issued 141R and Statement 160 that are big deals. First of all, they come out and then the accounting firms understandably write, well, here is what they're trying to say. Now, that might be a criticism of the standard, but anyway, they write those things. And they're very useful, we learn a lot from them. I used to do it in my old life but I read all the stuff that comes out.

And then, time goes by and firms begin to talk to each other and they realize that they don't agree on a particular point. And then, more time goes by and so there needs to be pressure taken off, is it important or not. And I don't know how this is going to work in the world of IFRS, but someone needs to answer the question maybe. Maybe it's not important. But there needs to be pressure taken off, who is going to do that.

Then, more time goes by and they begin to publish Q&A books. These are great books, they're very useful in answering questions. We accountants answer questions. So, what would you, I think all that is good. And at some point, if they can't resolve it amongst themselves, the SEC needs to resolve it or the EITF or give a speech. Or someone needs to know the answers.

I don't agree with Lynn that if we didn't like the speeches, we didn't want them published if we didn't like the answers. We wanted to know what the SEC had to say and we followed it once they spoke. So, the real world needs some implementation guidance, non-authoritative or otherwise, because not everybody can do it themselves.

MR. SIDWELL: And we agree with that. And I think all we were trying to do is differentiate between that which is authoritative and just really clarify where the line is between it and non-authoritative.

We've got ten minutes left, if the Chairman will allow us that amount of time.

CHAIRMAN POZEN: Sure.

MR. SIDWELL: We've covered I think the structural issues, if you like, that had been raised by many of you. What other areas do other members of the Committee or the panel just want to raise in these last few minutes? One I might quickly raise is just your views on post-adoption reviews. We had originally proposed almost a bright line on that which we're now thinking about backing away from and saying that there are enough processes that really will focus on when is the right time when a standard needs to be amended. Denny?

MR. BERESFORD: David, I'd just like to challenge John's comment. It seems to me that at least part of the thinking up until now is that we don't have to have an answer to everything, that we should be willing to trust the judgment of accounting firms and their clients and so forth to come up with reasonable answers within principles, within broad objectives. And apparently John feels differently. I know a lot of people feel differently about that, and that's pretty fundamental to what we've been doing in this whole project.

I'm not sure that there's one specific recommendation that says exactly that, but I think that is really kind of a principle underlying what we're doing here is that we don't have to have an answer to every question going forward.

MR. STEWART: This is John Stewart. I think that that as a value is a tough judgment as to how much non-comparability do you all think is acceptable. If you think there needs to be very little, then we'll need answers to most all of the questions. If you or users are willing to tolerate a significant amount of non-comparability, a significant amount of non-comparability, then we don't need to answer all the questions.

I was brought up thinking we need comparability, and therefore, think most questions do need to be answered. But if someone decides we don't need that much --

CHAIRMAN POZEN: Well, I think that's true, that you do give up a little non-comparability. The problem, as I think a number of people have said, is we can't possibly answer all the questions here. And that's, people can, there's a bit of schizophrenia. On the one hand, people complain that Bob's standards are much too long, they're much too long because people keep asking very specific questions so that it's sort of like a game that you can never win. And then, the second thing is we know that the more precise we give an answer, the more likely someone will figure out a way to structure around it.

So, I think these are the two concerns that people have, that if we go down the route that we've been trying to, we'll just get longer and longer standards. We'll never answer all the questions. We answer the questions we do, and then people are extremely clever in using that to come to results that people feel concerned about.

MR. STEWART: Yes, well, I don't agree with some of that. I don't think, I don't complain about Bob's standards being too long. I complain about them not being --

CHAIRMAN POZEN: Well, if I took a search of the literature, how many people complained about how long the hedging thing is. I bet you there were a thousand comments there.

MR. STEWART: Yes, I was speaking for myself. I'm here only representing me and no one else. But I don't complain about his standards being too long. I complain about them not being easy to understand or operationalize. That's not the same as being too long.

And then, second point is I don't agree that every time we answer a question someone will structure around it. I don't think that's true in a lot of questions that come up. There are just good faith differences where we need an answer. They're not structuring devices that someone is going to do something bad. They just want to know what the answer is.

CHAIRMAN POZEN: Well, I guess you're correct and it's not every case in which that's happening. But Bob would be the first to say he's trying to make it clear. The problem is he can't make it clear enough. There are always ambiguities.

MR. TURNER: But again, there is no silver bullet here, and I actually wholeheartedly agree with John on this point. The bottom line is you've got a lot of people asking questions about how do I get to an answer on this or that. If they're asking the questions, there's a reason they're asking the questions. There is a reason the CFO or controller wants to know those answers. You can't just turn around and tell them no, that just doesn't work.

And so, I think John is absolutely right. And for me, as someone who has run an investor research firm, Bob, consistency and comparability is the hallmark. If we lose consistency and comparability, I think we've got a problem. And I think to that point I couldn't agree more with John.

MR. SIDWELL: Joe, hold on a second. Mark first and then you, Joe.

MR. BIELSTEIN: Just a quick observation to follow along with some of these comments. I think it's also important, particularly because we deal with new standards, to recognize that we all get smarter as we deal with the standard over time. And just because we may have thought one provision of Statement 157 when it first came out should be interpreted one way but through continued work and dialogue new information comes to light and, well, maybe another way is a better way to interpret that, I think it needs to be recognized that those things are going to occur over time in some cases. And that doesn't necessarily mean that the first interpretation was necessarily an error or wrong.

CHAIRMAN POZEN: Yes, I agree with that.

MR. SIDWELL: Joe, do you want to have the last word?

MR. GRUNDFEST: No, but if I might ask a question? There is a similar problem in the common law system, all right, you know, and the legal system operates through common law process and the courts just answer the cases that are before them and they try not to reach any farther than that and to the extent the judiciary currently has a style that involves minimalist judging, you know. Yet we're able to make that system work, all right. We're able to make it work reasonably well, not perfectly.

And what I wonder is, is there something that the accounting standard setting system can learn from the common law process? And let me suggest what it might be, and it's not a perfect match. In the common law process, the vast majority of the cases wind up being settled because the people have to sit down and intelligently predict what the reasonable resolution would be if he went to trial. And it's just too expensive and dangerous to go to trial, so everybody is always inferring where the law will go. And we don't do a bad job of that, not a perfect job, all right.

Now, the difference in the accounting area is you don't have the discipline of an adversary process given the way it's currently operating. You have instead a standard and then you have a transaction that's not specifically covered or you think it's not specifically covered. You sit down, the reporting company sits down with its auditors and they come up with an interpretation and nobody knows about that interpretation. It's in effect a secret communication between the auditor and the company.

Now, what would happen if every time an issue of that sort came up -- that it was a requirement that the interpretation be made public in effect and be exposed so that that could be criticized and commented on and literature could develop around that interpretation, all right? Now, you can do the exposure without identifying the company. You can even set up a mechanism if you want where you can do the exposure without identifying the audit firm that adopted that interpretation. There are a variety of ways that that can be structured.

But you then have the discipline of in effect saying, wait a minute, if I'm taking this interpretation, if I have to expose it, will I then be called out by the system and by my peers for being an idiot? All right, for taking a totally unreasonable interpretation and caving one way or another? So, to me, the irony is here we are in a system that's talking about transparency, that's talking about disclosure, that's talking about clarity, yet many of the most difficult issues are raised, addressed and resolved in secrecy.

So, let me just suggest that as an approach, that if you put a question to your auditor, in order for you to be able to rely on your auditor's answer, you have to make public sufficient information that would allow third parties to understand the question asked, the answer given, all right. And I understand there can and should be a debate about whether you identify who the audit firm is, do you identify the company, you know, there could be commercial reasons for not doing that. But that way, we get the discipline of a piece of the common law process operating in accounting.

MR. TURNER: Joe, I would tell you that there is a good component of exactly that in what was proposed by Leonard Spacek who was chairman of Arthur Andersen at the time. And I'd urge you to go back and take a look at his recommendations in doing it, and it was along those lines. It set up what he then called an accounting court, but it would do I think and accomplish exactly what you're trying to do.

MR. GRUNDFEST: I don't think you need an accounting court at all.

MR. TURNER: Well, but it got it out publicly and people had to --

MR. GRUNDFEST: So, why has the profession not done that?

MR. TURNER: Because people don't like things out in public.

MR. GRUNDFEST: Why do they not like things out in public? Because they don't like what will happen, so maybe that's the reason why we should figure out how to get it out in public.

MR. TURNER: And I would totally support you on that.

MR. GRUNDFEST: Well, when Lynn and I agree on something, we've got to watch out.

CHAIRMAN POZEN: I think this is going over the old ground of, I mean, I think everybody would agree that it's useful to clarify certain things but we can't clarify everything. And if we could only figure out where exactly to be in the middle, we would all solve that particular solomonic problem.

But I think we've come to the end of this session. We appreciate very much all of you participating. We appreciate those people who have been patient enough on the phone where they haven't been hearing so well. And we will now have a lunch break and we will back around 1:30 to have Bob Herz from FASB addressing us. Thank you very much.

(Lunch recess.)

CHAIRMAN POZEN: For this part of the meeting, we want to have Bob Herz from FASB who is going to make a few remarks and some discussion. I wanted to personally thank Bob for the amount of time and effort he has put into our Committee and for the very serious and good faith negotiations between FASB and David's Subcommittee. I think they've been fruitful in really working toward a common goal. So, thanks for that and please take the floor, Bob.

MR. HERZ: Thank you. As you know, for a number of years before this Committee was --

CHAIRMAN POZEN: You've got to speak into the mic. We're still --

MR. HERZ: Yes. For a number of years before this effort was formally created, I had kind of, I guess for want of a better word, been kind of vocal and almost lobbying for an effort like this to be created because I felt from my own particular perch in this system that there were a lot of issues both with complexity and also with barriers to improving the reporting system for the benefit of investors and other users.

So, really I just want to personally thank each of the people, each of you on the Committee, the observers, the terrific staff for participating in this effort and really getting engaged in what is I think a very, very important and necessary effort. You know, that's why we were very pleased to donate a lot of Russ' time and our board members as active observers and other staff help as well. And certainly I give you my commitment that we will carefully consider any final recommendations of this group that are directed towards our activities.

CHAIRMAN POZEN: Bob, I'm going to just say that we were hoping for a little more and, you know, what we would like to be able to say in issuing the final report is that you support the report or you endorse it or this sort of thing. And as I have said to you, if there are issues, we should try to work them out. So, that would be helpful in terms of getting it some credibility.

MR. HERZ: Let me make my comments. I think --

CHAIRMAN POZEN: Okay, thank you.

MR. HERZ: I think that, from

our perspective, obviously all of what's in the report is relevant, but particularly the work of Subcommittees 1 and 2. I think we agree with the thrust of many, many of the key recommendations, you know, the preeminence of users. They are the customer. I think that gets to the heart of the purpose of financial reporting. The notion of trying to get more towards the single standard setter, we've been trying to do that. And many of the issues and recommendations related to substantive complexity, relating to notwithstanding some of the comments in different industry accounting models, optional accounting methods, competing models and the like.

I would make just one very minor point on one of the comments in, I think it's Subcommittee 1's report on substantive complexity, or at least the updated status report. It indicates that IFRS has less options in competing models. I think that's true in an absolute sense but I think you ought to recognize also that they have an option for fair value on a lot other things including property, plant and equipment, investment properties in that. That optional use of fair value is much more prevalent in their literature than it is in ours at the moment.

There are two other perhaps more significant matters related to substantive complexity that while the drafts of the status reports touch on that, I thought I'd just give you, really encourage you to maybe do a little further work on it and consideration. First, I'll deal with the issue, I'll call it “short-term-ism” and the hyper focus on quarterly earnings and earnings guidance and the whole kabuki dance that goes on in our system around that. There is a brief mention in Subcommittee 4's report that thought about that and that some view it as a source of complexity, but other groups have been looking at that. And that is true, I've been part of some of those other groups.

I think from where we sit, it is a major driver of complexity in our system. I think the desire for accounting methods that enable companies to manage, control, screw with the reported earnings to make them leads often to requests for build-to-suit accounting models or smoothing devices, and in some instances, the structuring of transactions to achieve the desired accounting results. And we do our best to react to that and try not to give in to all of that but the pressure is constant and it is a pervasive issue, I believe, in our financial reporting system.

I don't know everything to do. I think that actually there's a number of things in the report taken as a whole now that actually ought to take some credit for it that I think may help with this issue. It may not be enough exploration but there are some things. I think we talked about the issue, the 'chunk-alizing' the financial, the schedule and all of that. That may help along the lines of our financial statement presentation project.

I think Subcommittee 4's recommendations relating to key performance indicators and enhanced business reporting and approved disclosures and quarterly press releases, and corporate web sites, I also think that could help because it brings more granularity, more information, too. It might help get away from the whole focus on just one number each quarter and guessing the one number each quarter. And then, I think the judgment framework might help also in this regard.

I think it's important, but I think it's also important that there be some message given, I guess it's kind of in the report but that people treat financial reporting as a communication exercise and not just trying to comply or in some cases an opportunity to spin, to paint pictures that, you know, may not be as flattering as the underlying reality. And I would refer you to what I think was a pretty good discussion in a prior SEC report to Congress, I think it was the one on off balance sheet arrangements but it might have been the one on principles based accounting. That has a good discussion about this whole issue of financial reporting as communication and the like. So, I think that is a very important point when you're talking about substantive complexity in our system.

Another issue that I think is related to substantive complexity, relates to the education and training of accountants. Now, I was pleased to see that this issue is now being touched upon in Subcommittee 1, in the status report, in preliminary hypothesis 3.2. It does deserve consideration. There was some mention that the Treasury Advisory Committee is also looking at that. I'm not sure they're looking at it in all the elements that I would think it would need to be looked at and discussed.

I guess that, to me, it kind of boils down to a couple of important and related things. If accounting is supposed to reflect the “economic substance,” or the economic reality and it's supposed to be meant for the users, the consumers of the information, that I think we need to question to what degree our current accounting education system and training system provides a good enough grounding for accountants in the modern era on both economics and understanding how the financial information actually is used. I don't know how much is now taught at basic. My own believe is that you ought to learn economics, both macro and micro, before you start getting into debits and credits and all the rules in all of that.

And I also think you should learn to understand financial analysis, security valuation, business valuation. And I think we find that, as we develop new standards, part of the problem is people say I wasn't taught this stuff. I didn't learn it. I wasn't taught it this way. And then, it becomes kind of foreign and it does present a barrier in the system to moving forward the development of accounting that better serves the users and that better reflects the economic reality. So, I'd encourage you to -- you mentioned it now in the preliminary hypothesis -- I would encourage you to explore that, think about it.

Next, I'm sure that Bob, Jim and Russ will come down the home stretch and pull the report together. I think it's important that you identify and eliminate any obvious potential and internal inconsistencies in the recommendations so that holistically it seems to make sense. Now, one set of recommendations that Subcommittee 2 has done and we talked about it today again is the user preeminence. I think that is key. It is absolutely important. I think you need to gauge your own, the rest of the recommendations you have throughout the report against that goal in mind. And I'll just tell you that I think that you'd have heard from some of the users today but if we talk to some of the users there are some of the elements in the report that they don't view as consistent with that point of view and the like.

I think we had some discussion today about the fair value issue and we certainly agree that there is a need for a measurement framework but I would not be in favor of kind of a blanket moratorium. I mean, we've gotten urgent requests from the people in the brokerage and commodity trading area to clarify that physical commodity inventories that are traded can be carried at fair value because the SEC staff probably correctly has interpreted a 50-year-old piece of literature saying that generally can't be the case. Yet it's used as a part of an integrated trading strategy. So, we're going to do something on that.

We were visited a month or so ago by the REIT industry, not just the preparers but the key group of investors also and they said they want to move to fair value, that the current REIT financials at historic cost are misleading. And so, I think again, you know, caution I agree with. Moratoriums, I think that would be a little bit unwise.

Finally, I have to mention of course what I think was brought up in the second panel a little bit with what from our perspective is clearly the elephant in the room, and that is convergence and moving to IFRS in this country. You know, Subcommittee 2's status report I think does a good job of laying out that conundrum and issue and we're kind of caught in midstream here. This Committee began in August and since then a lot of things have been going on a parallel track related to our financial reporting system that could be very, really threshold issues for the whole system. And we have been proceeding in our organization and I think with agreement of the SEC staff, certainly our trustees, that we think the right place to get is to a single set of high quality standards and do it sooner rather than later. And it's important that we finish up as soon as possible on some of these major joint projects we have with the IASB.

I think that the SEC, you know, Chairman Cox has said he has asked the staff to develop a roadmap to get to that point with a date certain and the like. And so, in our discussions more recently with Subcommittee 2, what we did is we took some of the recommendations and we said they're very path -- how do they get implemented? They're all good recommendations, okay. It's a question of how we would implement them. And that implementation could be quite path dependent.

And we went through this and said okay, if you go under a presumption which has been the working presumption, or I don't know if it's a presumption or constraint so far, that US GAAP is going to be around for a significantly long period of time in this country, and convergence is not a priority, then here is how we would attempt to implement with it. If on the other hand we're on this other path which we are increasingly going down and we hear people in the system saying that that seems to be the path that most people want us to go down, here is how we would implement it and it would be a little bit different in some cases. I think that's not to knock the recommendations per se because I think, we think, do we good cost benefit this idea of going back post implementation -- those ideas are all good ideas? I think this idea of a financial reporting working group is a good idea under either path type of thing.

So, I just wanted to alert you to that. And really I alert you to it because I think that, if I were a voting member of this group, I would probably say, of course you're going to know a little bit more in June-July, if in fact that is the path we seem to be going down, to have a report that is premised on another path may not be ideal. It would be, it could be a little bit awkward. And I understand, I completely understand how we've gotten here because there has been this parallel track going on in it. But I just think that it is very important that a report that should have some durability and long-lastingness to it, that people just say, well, that's nice but that has nothing to do with what's going on. That's all I had.

CHAIRMAN POZEN: Well, I wanted to give everyone an opportunity to ask any questions of Bob. Does anyone have -- Jeff?

MR. DIERMEIER: And I know I think we've asked --

CHAIRMAN POZEN: You're going to again --

MR. DIERMEIER: This is Jeff Diermeier. Can you tell us a little bit more about the IASB-FASB joint presentation project and what the timing is expected on that?

MR. HERZ: The financial statement presentation project?

MR. DIERMEIER: Yes.

MR. HERZ: Yes. We had hoped to get out a first document, a discussion paper laying out the model including something like that schedule you have there and the operating, financing, investing distinctions and some other stuff probably about to wrap June or July I think it is. And the IASB's process demands for anything major, they have three steps. A discussion document that will be out for exposure probably six months because when you're dealing with them, they have to translate it into different languages and all of that, so that will be out then. We'll probably have public roundtables in different parts of the world, get the input and then we would take that and do what we call redeliberate towards an exposure draft. I would think that would come out probably towards the end of '09 to go through another round in all of that.

So, this project could be finished probably in 2011 kind of time frame.

CHAIRMAN POZEN: Scott?

MR. EVANS: Yes. Bob, you mentioned that you found in several places in the report inconsistencies with the notion of investor preeminence which you support. Then you mentioned fair value. But I wonder if there are any others that sort of are large in magnitude that we ought to really focus on.

MR. HERZ: Yes. Again, some of these, it's more from my talking with some of the investors. I think this issue of cost benefit, there is a view that in some places you're just trying to throw more sand into the gears. I don't think that was what was the intention at all but people are reading it that way on things like that. I'd have to go back through it in my notes to all that but, you know, you talk to some people and they say, gee, I hear that but it seems a lot -- oh, the materiality guidance I've heard about, the restatement, some users would say, look, I want the data we cast, I don't care.

MR. EVANS: We heard that one in San Francisco quite clearly.

MR. HERZ: Yes, so they kind of say I hear they say user preeminence but all their recommendations don't seem to stack up against that in a couple of places.

CHAIRMAN POZEN: Other comments or questions? I just want a take on the international, Bob. I guess this is something that David and I have really struggled with. And I guess in the end, the position that's in this paper is pretty much our position.

It's very difficult for us to deal with a moving target. And second of all, this is a moving target in which the difference in opinion between some of the big, heavy players is very large. So, it's, you know, I appreciate your position. I appreciate Chairman Cox's position. I don't really believe that it's a good idea for us to try to make a big move in this area. And we've thought about various things we could do but I don't know if they're realistic.

The other thing is, and you may disagree with me on this, Bob, but I've always taken the view that most things take longer than people expect. So, I guess Greenspan was worried that we were going to run out of treasury bills, but I wasn't worried. And I'm not worried that FASB is going to go out of existence too quickly.

MR. HERZ: I'm not either, Bob. Things are, other parts of the world are moving quickly and the desire amongst a lot of parties in this country to get there is fairly significant as long as it's high quality.

CHAIRMAN POZEN: That there is what?

MR. HERZ: As long as it's high, you know, remains high quality. It's the, you know, our goal is since this all started has been single set of high quality standards.

CHAIRMAN POZEN: Well, I can just, I have two data points that have happened recently. One is in the companies that I'm quite involved with which are large companies and the global companies. I must say, I don't see a strong militant effort to get into IFRS. I just don't see it. I mean, they'll go along with it but this is not at the top of their priorities.

And the second is I think what happened with Societe Generale where they moved the loss to the year before, that caught people's attention.

MR. HERZ: Yes, but that --

CHAIRMAN POZEN: Because that was not what most of the people in the investor community thought was a good result.

MR. HERZ: That was not a standards issue. That's an issue of application.

CHAIRMAN POZEN: Of application and interpretation. And I think all of us are sophisticated to know that that's probably going to be where the rubber really hits the road is the interpretation of these standards. And if the result of IFRS is that France can decide that it's okay for Credit Suisse to move small, several, you know, billion dollar loss from one year to another -- Societe Generale, sorry, you know, it's -- sorry.

So, all I'm saying is that I think we have done the best we can on this. But if anyone in the Committee disagrees, I think David actually has bent over backwards to try to do this and what we've written there. So, Greg, did you have something?

MR. SIDWELL: We should probably, there's one other, there's one important dimension which is the process --

CHAIRMAN POZEN: You have to speak closer into that.

MR. SIDWELL: The process to resolve many of these issues is ongoing at the SEC.

CHAIRMAN POZEN: Yes.

MR. SIDWELL: So, one of the issues we had as a Subcommittee is how do you engage where the SEC is very active soliciting points considering the comments that we've received before, discussing with regulators around the world. It's, I think as you say, Bob, it's very much a timing issue for us to productively add value. And I think the decision was that we couldn't add that value. I don't know if you want to add anything, Jim.

MR. KROEKER: Yes, certainly there is a very active process going on at the SEC, as everyone around this table knows, to consider those very issues. John, his chief accountant is working with Julie Erhardt on a roadmap to outline these exact issues as Bob talked about. So, I think there was some tension about what is it, while there's a process to reach out and get input from others to in fact develop this roadmap, that what is it that would be done from this Committee to add to that roadmap before it's even seen the light of day. The process is ongoing.

MR. HERZ: Well, it gets to the point that Bob said we'd like you to endorse the recommendations and all that. I'm telling you that on the path we're currently going, we sat down with the IASB last week at clearly the request of the SEC staff and updated our, the process of updating our MOU. And that's going to be the focus of a lot of our attention in the coming years. And it's going to demand working processes with them that demands some changes and the like. That doesn't make what you're doing irrelevant and all that, but it makes the implementation of them, will be implemented in ways that are appropriate for that.

CHAIRMAN POZEN: Well, I think all we would say, Bob, is the sorts of process suggestions we made, field studies, user consultation, post adoption review, we would hope that they would be built into whatever global standard process that's set up. I just don't think there is much more that we can add to this.

MS. GRIGGS: That's exactly right.

CHAIRMAN POZEN: So, these are the sorts of issues that are going to come up. But I think we can make clear our position that whatever this goes, it should be a uniform and consistent interpretive process and try to bulk that up.

MR. WHITE: Bob?

CHAIRMAN POZEN: John?

MR. WHITE: Just being on the drafting team here, we're obviously working on a roadmap. That would be a proposed roadmap that we would send to the Commission and then the Commission would have an open meeting and would put that out for comment. And you know, the time period between when the Commission puts something out for comment and when it would adopt something on a final basis, in other words, adopting a final roadmap is roughly four, five, six months gap in between those time periods.

And as to when, at least my personal view would be, when the Commission would be able to do this, I mean, it's not going to be this month, to start with that. So, you know, I don't know whether it's June or July or later, but I mean just in, and to look at kind of the term of this Committee, I guess I'm just trying to give you a few dates to look at. But I would have thought the earliest we'd get a roadmap out would be sometime around when this Committee finishes its charge.

MR. SIDWELL: I think --

MR. WHITE: A proposed roadmap out.

MR. SIDWELL: One thing we could do in the drafting of the final report, I think there are things, for instance, we've put in wording now about design of standards, there could be some of that which gets integrated with Subcommittee 1's so that it becomes a bit more of a package that could be handed off to whoever the standard setters are. So, I think we could think about, without a huge amount of reorganizing of our report, making some slight changes so that the design of standard has all these elements of no rules, bright lines and all of those other things that we've talked about. And it's sort of done in a more integrated way.

MS. BIES: And I would support David's idea because our Subcommittee has talked about that. In fact, one of the things we would hope is that IFRS doesn't diverge into industry specific accounting and some of our weaknesses. And so, we've tried in ours to be saying we would hope, again, that whoever the standard setter is, these are principles that are broadly applicable. So, I think we as a Subcommittee would support doing something like that.

MR. KROEKER: Just to clarify the timing of the roadmap into this Committee, I mean, it's certainly possible there could be a proposal out before that as well. It's just

The last paragraph in the text talks about the fact that the Subcommittee briefly discussed the notion of providing earnings guidance. In late September I think it is, NIRI, CFA Institute, Aspen Institute, CED, Business Roundtable, Chamber of Commerce and another group is going to have a forum on this whole subject as we continue.

CHAIRMAN POZEN: Well, let's see, I mean, let's do it without allocation of responsibility, I probably, since it's already been written several times. The question is does the Committee feel that we want to take on this issue? And I really, I don't know, Linda or Greg, I just say do we want to, I mean, when you sort of -- I guess there's an issue, two issues. One is whether we agree that we should discourage CEO's from projecting earnings in the next quarter. What people have usually said is if you have to do it, do a range and do it on a yearly basis so it gives you more flex. It's really an anti-short-time which I think there's general sympathy. But I don't know whether the Committee wants to make that plunge. I don't know.

MS. GRIGGS: Well, I know that a lot of my clients are not giving guidance on a quarterly basis anymore because I thought the trend was against that. I think it's --

CHAIRMAN POZEN: Yes. It is against it.

MS. GRIGGS: Yes.

CHAIRMAN POZEN: But it's still probably --

CHAIRMAN POZEN: Well, but I respect your position. Ed?

MR. WEATHERFORD: But I also think you need to have a combination, back to the KPI's, as I think to give the investors a full view is you have to have the combination of guidance and KPI's that they can understand. And they can see the trend of the business by looking at the trend of the KPI's. Then they'll decide whether to believe the guidance or not.

CHAIRMAN POZEN: Ed?

MR. McCLAMMY: Yes. We actually changed a couple of years ago to just giving annual guidance for all the reasons we're just talking here, and very infrequently update that unless something significant has changed. I think it's probably unrealistic to think that management will then get away from focusing on quarterly results because whether you put the guidance out or first call says here is what the number is, if you miss that number by a pin, you get punished. So, I'm not saying people do anything on a nefarious way to try to get that result, but to just take that number first call out of your mind is impossible.

CHAIRMAN POZEN: No, I think you're right on that, but I guess it does, most people would say it's a little less pressure if you've said it. And --

MR. McCLAMMY: Yes.

redressed, and rather than having a piecemeal build up, start with a framework that says here are the key things that investors should know. So, put disclosures on more of a principle based rather than rule based as well.

CHAIRMAN POZEN: Well, I think one of the problems, and this may be helpful, I think these are two rather different, they're under the same hypothesis but they are two very, very different proposals.

MS. GRIGGS: I agree.

CHAIRMAN POZEN: And we really need to separate them out. The second proposal is as you've just well articulated, a request that there be a much closer coordination between the SEC's disclosures and the financial footnotes. I think if there is some, I don't know whether there is already -- Russ, is there something anybody, I know that maybe we have talked about four or five years ago somebody had done some work on this in terms of the overlap? I mean --

MR. HERZ: Yes, I did it.

CHAIRMAN POZEN: Well, good then. You can --

MR. HERZ: It's been seven or eight years ago. I was part of the, it was an SEC GAAP redundancies working party.

CHAIRMAN POZEN: And has that been updated at all, Bob? Do you know whether anybody is working on

CERTIFICATION

I hereby certify the accuracy of this record of the proceedings of the SEC Advisory Committee on Improvements to Financial Reporting.

Robert C. Pozen

7/30/08

Robert C. Pozen
Committee Chair

Date

Exhibit A

Exhibit B

Note: These subcommittee reports have been prepared by the individual subcommittees and do not necessarily reflect either the views of the Committee or other members of the Committee, or the views or regulatory agenda of the Commission or its staff.

SEC Advisory Committee on Improvements to Financial Reporting
Substantive Complexity Subcommittee Update
May 2, 2008 Full Committee Meeting

I. Introduction

The SEC's Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.[1] In chapter 1 of the Progress Report, the Committee discussed its work-to-date in the area of substantive complexity, namely, its developed proposals related to industry-specific guidance and alternative accounting policies; its conceptual approaches regarding the use of bright lines and the mixed attribute model; and its future considerations related to scope exceptions[2] and competing models.

Since the issuance of the Progress Report, the substantive complexity subcommittee (Subcommittee I) has deliberated each of these areas further, particularly its conceptual approaches and future considerations, and refined them accordingly. This report represents Subcommittee I's latest thinking. The Subcommittee's consideration of comment letters received thus far by the Committee is ongoing and may result in additional changes. The purpose of this report is to update the full Committee, and also to serve as a basis for the substantive complexity panel discussions scheduled for May 2,

[1] Refer to Progress Report at http://www.sec.gov/rules/other/2008/33-8896.pdf.
[2] Throughout this report, the term "scope exceptions" refers to scope exceptions other than industry-specific guidance.

2008 in Chicago. Subject to further public comment, Subcommittee I intends to deliberate whether to recommend these preliminary hypotheses to the full Committee for its consideration in developing the final report, which it expects to issue in July 2008.

II. Exceptions to General Principles

II.A. Industry-Specific Guidance

In the Progress Report, the Committee issued a developed proposal related to industry-specific guidance (developed proposal 1.1). Refer to the Progress Report for additional discussion of this developed proposal. Subcommittee I will consider the panel discussions on May 2, 2008, as well as the public comment letters received, before submitting a final recommendation to the Committee, but at this time, is not intending to propose any significant revisions.

II.B. Alternative Accounting Policies

In the Progress Report, the Committee issued a developed proposal related to alternative accounting policies (developed proposal 1.2). Refer to the Progress Report for additional discussion of this developed proposal. Subcommittee I will consider the panel discussions on May 2, 2008, as well as the public comment letters received, before submitting a final recommendation to the Committee, but at this time, is not intending to propose any significant revisions.

II.C. Scope Exceptions

Preliminary Hypothesis 1: GAAP should be based on a presumption that scope exceptions should not exist. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB should not provide additional scope exceptions, except in rare circumstances. Any new projects should also include the elimination of existing scope exceptions in relevant areas as a specific objective of these projects, except in rare circumstances.

Background

Scope exceptions represent departures from the application of a principle to certain transactions. For example:[3]

- SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, excludes certain financial guarantee contracts, employee share-based payments, and contingent consideration from a business combination, among others.
- SFAS No. 157, Fair Value Measurements, excludes employee share-based payments and lease classification and measurement, among others.

[3] Refer to appendix A for additional examples.

- FIN 46R, Consolidation of Variable Interest Entities, excludes employee benefit plans, qualifying special-purpose entities,[4] certain entities for which the company is unable to obtain the information necessary to apply FIN 46R, and certain businesses, among others.

Similar to other exceptions to general principles, scope exceptions arise for a number of reasons. These reasons include: (1) cost-benefit considerations, (2) the need for temporary measures to quickly minimize the effect of unacceptable practices, rather than waiting for a final "perfect" standard to be developed, (3) avoidance of conflicts with standards that would otherwise overlap, and (4) political pressure.

Scope exceptions contribute to avoidable complexity in several ways. First, where accounting standards specify the treatment of transactions that would otherwise be within scope, exceptions may result in different accounting for similar activities (refer to competing models section below for further discussion). Second, scope exceptions contribute to avoidable complexity because of difficulty in defining the bounds of the scope exception. As a result, scope exceptions require detailed analyses to determine whether they apply in particular situations, and consequently, increase the volume of accounting literature. For example, the Derivatives Implementation Group has issued guidance on twenty implementation issues related to the scope exceptions in SFAS No.

[4] Subcommittee I notes that the FASB has tentatively decided to remove the qualifying special-purpose entity concept from U.S. GAAP and its exception from consolidation.

addressing the balance sheet classification of redeemable preferred stock not covered by SFAS No. 150.[5] Accordingly, as the FASB develops standards to address these transactions, the SEC should eliminate its related guidance.

From an international perspective, Subcommittee I notes that IFRS currently has fewer scope exceptions than U.S. GAAP. Accordingly, the Subcommittee will draft language for the full Committee's consideration, which if adopted, would encourage the SEC to affirm the IASB's efforts on this path. However, Subcommittee I also notes that, in certain circumstances where IFRS includes scope exceptions, they are sometimes more expansive than those under U.S. GAAP. For example, IFRS 3, Business Combinations, scopes out business combinations involving entities under common control, which results in no on-point guidance for such transactions. Accordingly, Subcommittee I also believes that where IFRS provides scope exceptions, the IASB should ensure any significant business activities that are excluded from one standard are in fact addressed elsewhere. Said differently, the IASB should avoid leaving large areas of business activities unaddressed in the professional standards.

II.D. Competing Models

Preliminary Hypothesis 2: GAAP should be based on a presumption that similar activities should be accounted for in a similar manner. As such, the SEC should recommend that any new projects undertaken jointly or separately by

[5] Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.

the FASB should not create additional competing models, except in rare circumstances. Any new projects should also include the elimination of competing models in relevant areas as a specific objective of these projects, except in rare circumstances.

Background

Competing models are distinguished here from alternative accounting policies. Alternative accounting policies, as explained in the Progress Report, 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[6] include different methods of impairment testing for assets such as inventory, goodwill, and deferred tax assets.[7] Other examples include

[6] Refer to appendix A for additional examples.
[7] For instance, inventory is assessed for recoverability (i.e., potential loss of usefulness) and remeasured at the lower of cost or market value on a periodic basis. To the extent the value of inventory recorded on the balance sheet (i.e., its "cost") exceeds a current market value, a loss is recorded. In contrast, goodwill is tested for impairment annually, unless there are indications of loss before the next annual test. To determine the amount of any loss, the fair value of a "reporting unit" (as defined in GAAP) is compared to its carrying value on the balance sheet. If fair value is greater than carrying value, no impairment exists. If fair value is less, then companies are required to allocate the fair value to the assets and liabilities in the reporting unit, similar to a purchase price allocation in a business combination. Any fair value remaining after the allocation represents "implied" goodwill. The excess of actual goodwill compared to implied goodwill, if any, is recorded as a loss. Deferred tax assets are tested for realizability on the basis of future

different methods of revenue recognition in the absence of a general principle, as well as the derecognition of most liabilities (i.e., removal from the balance sheet) on the basis of legal extinguishment compared to the derecognition of a pension or other post-retirement benefit obligation via settlement, curtailment, or negative plan amendment.

Similar to other exceptions to general principles, competing models arise for a number of reasons. These include: (1) scope exceptions, which, as discussed above, arise from cost-benefit considerations, temporary measures, and political pressure, and (2) the lack of a consistent and comprehensive conceptual framework, which results in piecemeal standards-setting.

Competing models contribute to avoidable complexity in that they lead to inconsistent accounting for similar activities, and they contribute to the volume of accounting literature.

On the other hand, competing models alleviate avoidable complexity to the extent that costs of a certain model exceed the benefits for a subset of activities.

<u>Discussion</u>

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expectations. The amount of tax assets is reduced if, based on the weight of available evidence, it is more likely than not (i.e., greater than 50% probability) that some portion or all of the deferred tax asset will not be realized. Future realization of a deferred tax asset ultimately depends on the existence of sufficient taxable income of the appropriate character (e.g., ordinary income or capital gain) within the carryback and carryforward periods available under the tax law.

Subcommittee I preliminarily believes that similar activities should be accounted for in a similar manner. Specifically, Subcommittee I acknowledges that competing models may be justified in circumstances in which the costs of applying a certain model to a subset of activities exceed the benefits. Further, Subcommittee I preliminarily believes that competing models may be justified as temporary measures (such as when they are temporarily needed to minimize the effect of unacceptable practices quickly, rather than waiting for a final "perfect" standard to be developed), as long as they are coupled with a sunset provision. To the extent a competing model meets one or more of the justifications above, it would not seem objectionable to use scope exceptions to clarify which accounting models cover various transactions (e.g., standard A ought to refer preparers to standard B for transactions excluded from the scope of A).

Subcommittee I recognizes that the FASB and IASB's joint project on the conceptual framework will alleviate some of the competing models in GAAP. However, Subcommittee I would encourage the implementation of this preliminary hypothesis prior to the completion of conceptual framework, where practical, as: (1) the conceptual framework is a long-term project and (2) current practice issues encountered in the standard-setting process will inform the deliberations on the conceptual framework.

Further, as new accounting standards are issued, including that which is issued through the convergence process, any competing models in related SEC literature should be revised and/or eliminated, as appropriate.

Subcommittee I notes that, in certain cases, IFRS currently has fewer competing models. For example, Subcommittee I notes that, unlike U.S. GAAP, the IFRS impairment model is generally consistent for tangible assets, intangible assets, and goodwill. As such, Subcommittee I will draft language for the full Committee's consideration, which if adopted, would encourage the SEC to affirm the IASB's efforts on this path, particularly as it works with the FASB on the joint conceptual framework.

III. Bright Lines

Preliminary Hypothesis 3.1: GAAP should be based on a presumption that bright lines should not exist. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB avoid the use of bright lines, in favor of proportionate recognition. Where proportionate recognition is not feasible or applicable, the FASB should provide qualitative factors for the selection of a single accounting treatment. Finally, enhanced disclosure should be used as a supplement or alternative to the two approaches above.

Any new projects should also include the elimination of existing bright lines in relevant areas to the extent feasible as a specific objective of those projects, in favor of the two approaches above.

Preliminary Hypothesis 3.2: Constituents should be better trained to consider the economic substance and business purpose of transactions in determining the appropriate accounting, rather than relying on mechanical compliance with rules. As such, the SEC should undertake efforts, and also encourage the FASB, academics and professional organizations, to better educate students, investors, preparers, auditors, and regulators in this respect.

Background

As noted in the Progress Report, bright lines refer to two main areas related to financial statement recognition: quantified thresholds and pass/fail tests.[8]

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,[9] where a mere 1% difference in the results of the quantitative tests leads to very different accounting.

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[8] Refer to appendix B of the Progress Report for additional examples of bright lines.

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

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

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

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

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

Discussion

Subcommittee I preliminarily believes that bright lines in GAAP should be minimized in favor of proportionate recognition. As a secondary approach, where proportionate recognition is not feasible or applicable, the Subcommittee recommends that GAAP be based on qualitative factors, supported by presumptions[10] as necessary. Subcommittee I also preliminarily believes that disclosure may be used as a supplement or alternative to the approaches above.

Subcommittee I uses the term "proportionate recognition" to describe accounting for the rights and obligations in a contract. In contrast to the current all-or-nothing recognition approach in GAAP, Subcommittee I preliminarily believes that accounting for rights and obligations would be appropriate in areas such as lease accounting – in effect, an entity would fully recognize its <u>rights to use</u> an asset, rather than the physical asset itself. In these cases, regardless of whether the lease is considered to be operating or capital (based on today's dichotomy), all entities would record amounts in the financial statements to the extent of their involvement in the related business activities. For example, consider a lease in which the lessee has the right to use a machine, valued at $100, for four years. Also assume that the machine has a 10-year useful life. Under proportionate recognition,

[10] In order for the use of presumptions to be meaningful and consistently applied, Subcommittee I preliminarily believes that the FASB should adopt consistent use of terms describing likelihood (e.g., rare, remote, reasonably possible, more likely than not, probable), time frames (e.g., contemporaneous, immediate, imminent, near term, reasonable period of time), and magnitude (e.g., insignificant, material, significant, severe).

a lessee would recognize an asset for its right to use the machine (rather than for a proportion of the asset) at approximately $35[11] 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. Similarly, this rights-and-obligations approach may also be relevant in the context of revenue recognition, in particular, in comparison to today's software revenue recognition model.

However, Subcommittee I recognizes that proportionate recognition is not universally applicable. For example, proportionate recognition is not applicable in situations where the economics of a transaction legitimately represent an all-or-nothing scenario. [12] In situations like these, the FASB should consider providing qualitative factors, supported by presumptions, to guide the selection of a single appropriate accounting treatment by preparers. Subcommittee I preliminarily believes qualitative factors, including presumptions, would promote the application of principles over compliance with rules, while still narrowing the range of interpretation in practice to facilitate comparability across companies. Admittedly, presumptions may result in all-or-nothing accounting, but differ from bright lines because they are not arbitrary or determinative in their own right.

[11]For purposes of illustration, $35 represents a company's net present value calculations. The example is only intended to be illustrative and is not prescriptive. The basis of proportionate recognition may be an asset's estimated useful life, its future cash flows or some other approach depending on the facts and circumstances.

[12] Examples include determining (1) whether a contract should be accounted for as a single unit of account or whether it should be split into multiple components, and (2) whether a contract that has characteristics of both liabilities and equity should be treated as one instead of the other.

Subcommittee I uses the term “presumptions” to describe a method by which an accounting conclusion may be initially favored (i.e., not stringently applied), subject to the consideration of additional factors. This approach is used to some extent today. For instance, the business combination literature contains an example of a presumption coupled with additional considerations.[13] There are situations in which selling shareholders of a target company are hired as employees by the purchaser because the purchaser may wish to retain the sellers’ business expertise. The payments to the selling shareholders may either be treated as: (1) part of the cost of the acquisition, which means the payments are allocated to certain accounts on the purchaser’s balance sheet, such as goodwill, or (2) compensation to the newly-hired employees, which are recorded as an expense in the purchaser’s income statement, reducing net income. Some of these payments may be contingent on the selling shareholders’ continued employment with the purchaser, e.g., the individual must still be employed three years after the acquisition in order to maximize the total sales price. GAAP provides several factors to consider when deciding whether these payments should be treated as an expense or not, but establishes a presumption that any future payments linked to continued employment should be treated as an expense. It is possible this presumption may be overcome depending on the circumstances.

[13] Emerging Issues Task Force (EITF) 95-8, Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination. Subcommittee I notes EITF 95-8 is nullified by a new FASB standard, SFAS No. 141 (revised 2007), Business Combinations. SFAS No. 141 (revised 2007) states “A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation…” However, the guidance in EITF 95-8 is still helpful in describing our approach with respect to the use of presumptions coupled with additional considerations in GAAP.

Finally, Subcommittee I notes that disclosure is critical to communicating with users, either by supplementing financial statement recognition (proportionate or otherwise) or by discussing events and uncertainties outside of the financial statements. Subcommittee I preliminarily believes that in some cases, disclosure may be more informative than recognition, as point estimates recognized in financial statements may provide a misleading sense of precision. Subcommittee I discusses examples of this situation in its consideration of a disclosure framework (section V of this report).

In order for these preliminary hypotheses to be operational, Subcommittee I recognizes the need for a cultural shift towards the acceptance of more judgment. In this regard, Subcommittee I preliminarily believes that professional judgment framework discussed in developed proposal 3.4 is critical to the success of these preliminary hypotheses. Subcommittee I further notes that even if the FASB limits its use of bright lines, other parties may continue to create similar non-authoritative guidance, which may proliferate the use of bright lines. As such, Subcommittee I preliminarily believes that developed proposal 2.4 regarding the reduction of parties that formally or informally interpret GAAP is helpful.

From an international perspective, Subcommittee I notes that IFRS currently has fewer bright lines than U.S. GAAP. Consequently, Subcommittee I will draft language for the full Committee's consideration, which if adopted, would encourage the SEC encourage to affirm the IASB's efforts on this path.

With respect to training and educational efforts, Subcommittee I notes the U.S. Treasury Department's Advisory Committee on the Auditing Profession has offered a number of preliminary recommendations on this topic. The Subcommittee is generally supportive of their direction, and will draft language for the full Committee's consideration, which if adopted, would encourage the SEC to monitor these developments as it takes steps, in coordination with the FASB, to promote the ongoing education of all financial reporting constituents.

IV. Mixed Attribute Model

As previously noted in the Progress Report, the mixed attribute model is one in which the carrying amounts of some assets and liabilities are measured at historic cost, others at lower of cost or market, and still others at fair value. There are several measurement attributes that currently exist in GAAP, all of which result in combinations and subtotals of amounts that are not intuitively useful. This complexity is compounded by requirements to record some adjustments in earnings, while others are recorded in equity (i.e., comprehensive income). For example, changes in the fair value of a derivative may be charged directly to equity, while an asset's current period depreciation expense reduces net income.

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

In practice, the costs associated with (potentially uncertain) fair value estimates can be considerable. Some preparers' knowledge of valuation methodology is limited, requiring the use of valuation specialists. Auditors often require valuation specialists of their own to support the audit. Some view the need for these valuation specialists as a duplication of efforts, at the expense of the preparer. In addition, there are recurring concerns about second-guessing by auditors, regulators, and courts in light of the many judgments and imprecision involved with fair value estimates. Regardless of whether such estimates are prepared internally or by valuation specialists, the effort and elapsed time required to implement and maintain mark-to-model fair values is significant. For these reasons, preparers and auditors will likely have to incur costs to broaden their proficiency in basic valuation matters,[18] and additional education may be required for the larger financial reporting community to become further accustomed to fair value information.

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

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[18] For instance, additional training for field auditors may be necessary to lessen dependency on valuation experts.

Therefore, as the Committee noted in its Progress Report, Subcommittee I assumes that a complete move to fair value is most unlikely. Within this context, the partial use of fair value increases the volume of accounting literature. Said differently, when more than one measurement attribute is used, guidance is required for each one. In addition, some entities may operate under the impression that investors are averse to market-driven volatility. Consequently, entities have demanded exceptions from the use of fair value in financial reporting, resisted its use, and/or entered into transactions that they otherwise would not have undertaken to artificially limit earnings volatility. These actions have resulted in a build up in the volume of accounting literature. More generally, some believe that attempts by companies to smooth amounts that are not smooth in their underlying economics reduce the efficiency and the effectiveness of capital markets.

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

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

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

Fair value also eliminates issues surrounding management's intent. For example, entities are required to evaluate whether investments are impaired. Under certain impairment models, entities are currently required to assess whether they have the intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. As the Committee noted in the in the Progress Report (see discussion supporting developed proposal 1.2 to minimize alternative accounting policies) management intent is subjective and, thus, less auditable. However, use of fair value would generally make management intent irrelevant in assessing the value of an investment.

Discussion

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

Therefore, consistent with current practice, Subcommittee I preliminarily believes fair value should not be the only measurement attribute in GAAP. At present, Subcommittee I believes the Committee should advise caution about expanding the use of fair value until a systematic measurement framework is developed, and in this regard, that phase two of the FASB's fair value option project, which will consider permitting fair value measurement for certain nonfinancial assets and liabilities, should not be finalized prior to completion of a measurement framework.[19]

[19]Similarly, Subcommittee I preliminarily believes the Committee should recommend that the FASB consider deferring provisions of new standards that are issued, but not yet effective, which expand the use of fair value measurement where it has not been previously required.

At that point, the FASB should determine measurement attributes based on considerations such as business activity, the relevance and reliability of fair value inputs, and other considerations vetted during the measurement phase of its conceptual framework project. While Subcommittee I prefers an activity-based approach to assigning measurement attributes, Subcommittee I is sympathetic to an approach based on the type of asset or liability in question, such as financial instruments vs. non-financial instruments. This is a natural tension that the FASB should address as part of the measurement framework. For example, in one scenario, the Board may determine amortized cost is the presumptive measurement attribute within the operating section of a company's financial statements. Nevertheless, the Board would also have to consider whether fair value is appropriate for financial assets and liabilities employed in those business activities such as certain derivative contracts used to hedge commodity price risk for materials used in the production process.

With respect to financial statement presentation, Subcommittee I preliminarily believes the grouping of individual line items (and related measurement attributes) by operating, investing and financing activities would alleviate some of the concerns about fair value in particular. It would also reduce confusion caused by the commingling of all measurement attributes. Subcommittee I preliminarily believes this presentation would be more understandable to investors, particularly because it would delineate the nature of changes in income (e.g., fair value volatility, changes in estimate) and allow users to assess the degree to which management controls each one.

It may also facilitate earnings analyses by business activities that correspond to the natural elements of most profit-driven entities, for instance, operating income compared to investing or financing results. Under this approach, companies should present earnings per-share computations of the net activity in each section. Further, the addition of a new primary financial statement – the reconciliation of the statements of comprehensive income and cash flows – would disaggregate changes in assets and liabilities based on cash, accruals, and changes in fair value, among others. A visual example of this statement might include the following:[20]

Reconciliation of the Statements of Income and Cash Flows

	A	**B**	**C**	**D**	**E**	**F**	
		Non-cash items affecting income					
	Cash Flow Statement	Cash flows Not Affecting Income	Accruals and Systematic Allocations	Recurring Valuation Changes	Other Valuation Changes	Income Statement (A+B+C+D+E)	
Operating							
Cash received from sales	2,700,000		75,000			2,775,000	Sales
	0		(9,000)			(9,000)	Depreciation expense
	0				(15,000)	(15,000)	Impairment expense
	0			(7,500)		(7,500)	Forward contract adj.
Investing							
Capital expenditures	(500,000)	500,000				0	
Sale of available for sale securities	5,000	(4,900)		350		450	Realized gain on sale
Financing							
Interest paid	(125,000)		(100,000)			(225,000)	Interest expense

Subcommittee I preliminarily believes that the correlation of rows and columns in this schedule will help users assess different elements of financial performance, e.g., sales is comprised primarily of cash receipts, but also end of period accruals. Recognizing

[20] Subcommittee I has adapted and modified this table from a similar schedule in the FASB's financial statement presentation project.

companies will use different titles for income statement line items, Subcommittee I preliminarily believes the predominant value of this schedule is the columnar depiction of measurement attributes and the context it provides for earnings analysis. For example, users should be better equipped to form opinions about a company's earnings quality and the predictability of its future cash flows because they are generally unable to prepare similar reconciliations based on today's financial statements. While this revised presentation does not resolve all of the challenges posed by the mixed attribute model, it represents an improvement over the current approach for investors to understand a company's financial condition and operating results.

From an international perspective Subcommittee I notes the mixed attribute model also exists under IFRS. As such, Subcommittee I preliminarily believes that this preliminary hypothesis applies equally to IFRS, particularly as the IASB works with the FASB on the joint financial statement presentation project.

<u>V. Disclosure Framework</u>

Disclosure provides important context for the estimates and judgments reflected in the financial statements. It also highlights uncertainties outside of the statements that could impact financial performance in the future.

Subcommittee I preliminarily believes that any recommendations regarding new disclosure guidance will be most effective and informative for investors if the FASB and SEC update, or as necessary, rescind outdated or duplicative disclosure requirements. Subcommittee I's preliminary hypothesis advocates establishing a process to achieve this goal.

Preliminary Hypothesis 5: The SEC should request the FASB to develop a disclosure framework to:

- **Require disclosure of the principal assumptions, estimates and sensitivity analyses that may impact a company's business, as well as a qualitative discussion of the key risks and uncertainties that could significantly change these amounts over time. This would encompass transactions recognized and measured in the financial statements, as well as events and uncertainties that are not recorded, such as certain litigation and regulatory developments.**
- **Integrate existing disclosure requirements into a cohesive whole by eliminating redundant disclosures and providing a single source of disclosure guidance across all accounting standards.**

The SEC and FASB should also establish a process of coordination for the Commission to regularly update and, as appropriate, remove portions of its disclosure requirements as new FASB standards are issued.[21]

[21] The Committee considers coordination between the SEC and the FASB in chapter 2 of the Progress Report, particularly conceptual approaches 2.A and 2.C.

because it is not feasible for standards-setters to envision all of the specific future disclosure requirements that would be necessary in different settings.

For example, in the wake of the recent “liquidity crisis,” there has been significant focus on disclosures related to off-balance-sheet entities. Of particular interest is disclosure of structured investment vehicles (SIVs).[22] Recently, certain sponsoring banks have provided liquidity support to SIVs that were unable to sustain financing in the short-term commercial paper market. In some cases, this led the sponsors to consolidate the SIVs under FASB Interpretation No. 46(R), which added billions of dollars of assets and liabilities to the sponsors’ balance sheets. Consequently, some constituents have criticized existing disclosure practices and called for standards-setters to require additional “early-warning” disclosure about off-balance sheet activity (e.g., types of assets held by the SIVs, circumstances that may result in consolidation or loss, and methodologies used to determine fair value and related write-downs). Others counter that: (1) major SIV sponsors already disclosed the magnitude of their investments in off-balance sheet entities prior to the liquidity crisis and (2) further detail would have been uninformative and potentially confusing to users because it would have amounted to “disclosure overload.” For instance, at the time the decision not to consolidate was

[22] From a review of SEC filed documents, Subcommittee I has identified seven SEC filers that sponsored SIVs around the time of the liquidity crisis. Prior to the crisis, most of these filers did not provide quantified disclosure of the unconsolidated SIVs’ assets and liabilities (in some cases, SIV assets and liabilities were aggregated with the assets and liabilities of other off-balance sheet arrangements—collectively, “VIEs”). Subsequent to the crisis, Subcommittee I notes that some sponsors have expanded their disclosures to include additional quantitative information, as well as qualitative disclosures such as the nature of SIV assets, descriptions of SIV investment and operating strategies, risks related to the current environment, and sponsors’ obligations to the SIVs.

reached, some sponsors may have concluded it was quite unlikely that events which might lead to consolidation would actually occur, and that discussion of these scenarios was unnecessary. These two opposing points of view highlight the tension noted above, namely, that some constituents prefer detailed, prescriptive disclosure guidance, while others favor a more principled approach.

Discussion

Specifically, Subcommittee I preliminarily believes that at a minimum, an effective disclosure framework is comprised of three basic elements: (1) a description of the transactions reflected in financial statement captions, (2) a discussion of the relevant accounting provisions, and (3) an analysis of the key supporting judgments, risks and uncertainties.[23] In the following commentary, we focus largely on the third element.

Within the financial statements, a disclosure framework should more effectively signal to investors the level of imprecision associated with significant estimates and assumptions, particularly some fair value measurements. This can be achieved by disclosing the principal assumptions, estimates and sensitivity analyses that impact a company's business, as well as a qualitative discussion of the key risks and uncertainties that could significantly change these amounts over time. For example, Subcommittee I notes that in

[23] Subcommittee I acknowledges the work of the FASB's Investors Technical Advisory Committee on the topic of a disclosure framework. Subcommittee I preliminarily agrees with the need to establish a principles-based approach to future disclosure standards and has adapted certain elements of ITAC's thinking in this discussion.

certain 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. While SFAS No. 157, Fair Value Measurements, established disclosure requirements that provide insight into Level 2 and 3 fair value estimates,[24] it may not be sufficient in all cases. Many investors might find information about the key assumptions in a valuation model, key risks associated with those assumptions,[25] and related sensitivity analyses helpful, as well as an understanding of how "fat" or "thin" the tails of statistical modeling techniques are.[26]

Outside of the financial statements, disclosure of environmental factors may be more meaningful than attempting to "force" a wide range of probabilities into a single point estimate on the balance sheet or income statement. This would encompass events and uncertainties such as relevant market conditions, off-balance sheet activity, litigation and regulatory developments. Some constituents argue that recording an estimate to reflect these events, instead of disclosing them, may actually provide a misleading sense of precision. Alternatively, they suggest companies could communicate to investors more effectively by disclosing the factors that might trigger financial statement recognition, the magnitude of possible and/or probable transactions, and management's plans in those scenarios.

[24] Statement 157 established a three level fair value hierarchy. It assigns highest priority to quoted prices in active markets (Level 1) and the lowest priority to unobservable inputs that rely heavily on assumptions (Level 3).

[25] For example, if a valuation model relies on historical assumptions for a period of time that does not include economic downturns, that fact and its implications may need to be disclosed.

[26] In statistics, this notion is known as the "goodness of fit," which describes how well a statistical model fits a set of observations. These are quantified measures that summarize the discrepancy between observed values compared to values predicted by the model. Large discrepancies can be described as "fat," while small discrepancies are "thin."

In any event, Subcommittee I acknowledges some disclosure guidance establishes a "floor" for communication between companies and investors, rather than a "ceiling."[27] Our preliminary hypothesis offers a more cohesive structure for the narrative that supports and explains the financial statements, but Subcommittee I believes preparers should take the initiative in tailoring financial reports for users.

Subcommittee I also recognizes the proposed disclosure framework incorporates factual information that, historically, is presented in audited footnotes, as well as analytical and forward-looking discussions that are typically part of MD&A narratives in SEC filings. Subcommittee I acknowledges that there are important considerations regarding assurance and legal issues when determining the placement of disclosures in a filing (e.g., footnotes or MD&A). Therefore, an optimally-designed disclosure framework should be developed by the FASB under close coordination with the SEC so that the Commission can amend its guidance accordingly (e.g., Regulations S-K and S-X).

Beyond these concerns, the SEC or its staff should also update, and as needed remove, portions of public company disclosure guidance that are impacted by new FASB standards. Subcommittee I is aware of studies in the past conducted to identify overlaps

[27] Subcommittee I notes companies are not precluded from providing disclosure of the type proposed here. Indeed, certain existing guidance is largely consistent with our views, such as APB Opinion No. 22, Disclosure of Accounting Policies, SOP No. 94-6, Disclosure of Certain Significant Risks and Uncertainties, Item 303(a) of Regulation S-K related to Management's Discussion and Analysis, and FRR 60, Cautionary Advice Regarding Disclosure about Critical Accounting Policies.

of this type.[28] Unless the SEC or its staff establishes a monitoring process to update its disclosure requirements, similar studies may be necessary in the future. Additionally, if developed proposal 1.1 to minimize industry-specific accounting guidance is adopted, the SEC or its staff may need to consider revising its Industry Guides in Items 801 and 802 of Regulation S-K.

From an international perspective, Subcommittee I notes that IAS 1, Presentation of Financial Statements, includes some of the elements that Subcommittee I would expect of a disclosure framework, such as a principle for: (1) what the notes to the financial statements should disclose, (2) footnote structure. (3) disclosures of judgments, and (4) disclosures of key sources of estimation or uncertainty, including sensitivity analyses. Nonetheless, Subcommittee I preliminarily believes that its preliminary hypothesis in this area would also result in improvements to IFRS.

[28] In particular, the 2001 FASB report on "GAAP-SEC Disclosure Requirements," which was a part of a larger Business Reporting Research Project.

- Different models for when to recognize for impairment of assets such as inventory, goodwill, long-lived assets, financial instruments, and deferred taxes.

- Different likelihood thresholds for recognizing contingent liabilities, such as probable for legal uncertainties versus more-likely-than-not for tax uncertainties.

- Different models for revenue recognition such as percentage of completion, completed contract, and pro-rata. Models also vary based on the nature of the industry involved, as discussed in other sections.

- Derecognition of most liabilities such as on the basis of legal extinguishment, as compared to the derecognition of pension and other post-retirement benefit obligations via settlement, curtailment, or negative plan amendment.

- Different models for determining whether an arrangement is a liability or equity.

Exhibit C

SEC Advisory Committee on Improvements to Financial Reporting
Standards-Setting Subcommittee Update
May 2, 2008 Full Committee Meeting

I. Introduction

The SEC's Advisory Committee on Improvements to Financial Reporting (the Committee) issued a Progress Report (the Progress Report) on February 14, 2008. In chapter 2 of the Progress Report, the Committee discussed its work to date on the standards-setting process, namely its:

- Developed proposals related to increased investor participation, FAF and FASB governance, standards-setting process improvements and interpretive implementation guidance;
- Conceptual approaches regarding clarifying the SEC's role in standards-setting, design of standards and the FASB's priorities; and
- Future considerations related to international governance.

Since the issuance of the Progress Report, the standards-setting subcommittee (Subcommittee II) has deliberated each of these areas further, particularly its conceptual approaches and future considerations and is in the process of refining them accordingly. This report presents a summary of Subcommittee II's latest thinking and serves as an update to the Committee. The Committee is also hosting panel discussions on May 2, 2008, in Rosemont, IL. Subcommittee II will re-deliberate each of these topics based on testimony received, guidance to be provided by the Committee and comment letters received thus far by the Committee. The Committee will deliberate any new proposals and proposed revisions to existing developed proposals in July 2008.

II. Current Status and Further Work

International Considerations

The Committee deferred deliberation of international considerations until 2008. Subcommittee II acknowledges that the SEC has already received significant input associated with its (1) removal of the U.S. GAAP reconciliation for foreign private issuers reporting under IFRS as promulgated by the IASB and (2) concept release on the possibility of allowing domestic issuers to report under IFRS as promulgated by the IASB. Subcommittee II also observes that debates regarding both the end state of international convergence (that is, a single set of high quality global accounting standards) and the best way to accomplish that objective in the U.S. (that is, the transition) are underway among standards-setters, their governance bodies, the international regulatory community and others. After discussion with the SEC staff and in light of these ongoing deliberations, which include SEC staff consideration of comments received in response to the concept release, input from roundtables, and the staff's work on developing a roadmap for consideration by the Commission at the request of Chairman Cox, Subcommittee II does not intend to advance detailed proposals at this time.

Although an analysis of how the international standards-setting processes could be improved was not in the Committee's mandate, Subcommittee II believes that many of the Committee's developed proposals and conceptual approaches may be equally applicable in international standards-setting. Subcommittee II also noted that an important U.S. convergence question has not been openly debated in the public forum—how the SEC will fulfill its regulatory responsibility without creating a U.S. jurisdictional variant of IFRS.

Although not intending to recommend detailed proposals, Subcommittee II is deliberating whether the Committee should consider:

- expressing high-level support for moving to a single set of high quality accounting standards in the U.S.,
- supporting the SEC's efforts to develop an international convergence roadmap, and
- encouraging all participants in the financial reporting community to increase coordination to foster consistency in global interpretations and avoid jurisdictional variants of IFRS.

The final determination of whether Subcommittee II's deliberations will result in a developed proposal will not be known until later in 2008.

FASB Dialogue

Since the Committee issued its Progress Report, Subcommittee II has engaged representatives of the FASB in a dialogue regarding the Committee's developed proposals and conceptual approaches. As a result of this dialogue, as well as the public comments received on the Progress Report, Subcommittee II is currently deliberating potential modifications to the Committee's proposal for Committee deliberation as its final recommendations.

A number of tentative modifications are being contemplated, which are summarized as follows:

- International—The Committee's proposals assume that U.S. GAAP will continue to be in use for a number of years. However, convergence matters significantly drive priorities in standards-setting. Subcommittee II plans to propose clarifying the Committee's proposals that will be impacted by the ultimate path chosen by the SEC regarding international convergence.
- Governance—Subcommittee II plans to propose updating the Committee's proposals for recent changes made by the FAF, including emphasizing which proposals have yet to be fully addressed. Specifically, Subcommittee II is deliberating whether the FAF resolutions regarding increased investor representation on the FAF and FASB will meet the objective underlying the Committee's developed proposal. Subcommittee II would also like to emphasize the importance of the FAF establishing clear performance metrics related to the efficiency and effectiveness of standards-setting and may propose withdrawing the statement that academic representation should not be mandated on the FASB.

- Investors—Subcommittee II plans to propose integrating the discussion of investor pre-reviews into developed proposal 2.1 and propose clarifying that although investor involvement in standards-setting has been improved recently, more formalized, structured involvement utilizing existing advisory groups would be warranted, particularly before a document is issued for exposure. In addition, Subcommittee II plans to propose clarifying the Committee's view about the "significance" of investor involvement to further promote balanced standards-setting.
- Agenda—Subcommittee II plans to propose clarifying that the proposed Agenda Advisory Group was intended to be comprised of key decision makers from the SEC, FASB, PCAOB and other constituent groups that would meet on a real-time basis to address immediate needs in the financial reporting system at large. Such a Financial Reporting Working Group would not solely advise the FASB on its agenda. Involvement of other constituents could be effectuated by leveraging members or executive committees from existing FASB advisory groups. This may require the FAF and FASB to reevaluate the composition and responsibilities of other FASB advisory groups and agenda committees, as well as what input is requested of them and when, to improve the efficiency and effectiveness of standards-setting.
- Field Work—Subcommittee II plans to propose clarifying that the intent of the proposals on cost-benefit analyses and field work were that these processes would benefit from additional consistency across major projects and transparency of the process followed and conclusions reached.

- Periodic Reviews—Subcommittee II plans to propose clarifying that the Committee's proposals regarding periodic reviews of new and existing standards were intended to formalize existing standards-setting processes for major projects. Subcommittee II may also propose dispensing with a bright line time requirement, due to the inconsistency of this approach with other Committee proposals and the need for the standards-setter and its advisory groups to evaluate the facts and circumstances surrounding each major project.

Clarifying SEC Role in Interpreting GAAP

Subcommittee II understands that the SEC staff is already in the process of instituting internal processes that may address many, if not all, of the points in the Committee's conceptual approach 2.A regarding SEC interpretations of GAAP. Subcommittee II is in the process of formulating a developed proposal that considers such improvements, which will be presented to the Committee for consideration in July 2008.

Standards-Setting Priorities

Conceptual approach 3.C recommends revisiting standards-setting priorities. However, Subcommittee II acknowledges that convergence matters significantly drive priorities in standards-setting and that the convergence paths being considered by the SEC will directly impact certain of the Committee's proposals and U.S. standards-setting priorities. As such, conceptual approach 2.C may not lead to a proposal being presented to the

Committee, as this reprioritization is likely already being considered by those involved in the international convergence dialogue and could be addressed with assistance from the proposed Financial Reporting Working Group. However, Subcommittee II is deliberating the feasibility of a phase II codification project, subject to its path-dependency on international convergence matters, within the Committee's discussion of the FASB's current codification project and proposed periodic reviews of existing standards. The Committee will deliberate this topic in July 2008.

Design of Standards

Subcommittee II has drafted a preliminary hypothesis related to the design of accounting standards based on conceptual approach 2.B from the Progress Report for the Committee's consideration, as follows:

> **Preliminary Hypothesis:** **The SEC should encourage the FASB to continue to improve the way accounting standards are written by using clearly-stated objectives, outcomes and principles that faithfully represent the economics of transactions and are responsive to investors' needs for clarity, transparency and comparability.**

Design of Standards: As noted in the Progress Report, some participants in the U.S. financial reporting community believe that certain accounting standards do not clearly articulate the objectives, outcomes and principles upon which they are based, because they are sometimes obscured by dense language, detailed rules, examples and illustrative guidance. This can create uncertainty in the application of GAAP. Further, the proliferation of detailed rules fosters accounting-motivated structured transactions, as rules cannot cover all outcomes. As discussed in chapter 1 of the Progress Report, standards that have scope exceptions, safe harbors, cliffs, thresholds and bright lines are vulnerable to manipulation by those seeking to avoid accounting for the substance of transactions using structured transactions that are designed to achieve a particular accounting result. This ultimately hurts investors, because it reduces comparability and the usefulness of the resulting financial information. Therefore, a move toward the use of more objectives, outcomes and principles in accounting standards may ultimately improve the quality of the financial reporting upon which investors rely.

The Committee recognized in the Progress Report that the question of how to design accounting standards going forward is a critical aspect of the standards-setting process and is at the center of a decade-long principles-based versus rules-based accounting standards debate. There has been much discussion in the marketplace on this topic and there are differing views. The SEC has been a frequent participant in the debate and has long been supportive of objectives-oriented standards.[1] Rather than engage in such a spurious debate, the Committee preferred in the Progress Report to think of the design of accounting standards in terms of the characteristics they should possess. There are many

[1] For example, the SEC issued Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter (April 2003), which included numerous recommendations for the FAF and FASB to consider, including greater use of principles-based accounting standards whenever reasonable to do so. The SEC staff also issued Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (July 2003), which further lauded the benefits of objectives-oriented standards.

publications on this topic written by well-known theorists from the FASB, the IASB, the SEC, accounting firms, academia and elsewhere. The most recent example is an omnibus of this collective thinking published by the CEOs of the World's Six Largest Audit Networks.[2] Their paper attempts to outline what optimal accounting standards should look like in the future and proposes a framework the standards-setter should refer to over time to ensure that these characteristics are consistently optimized.

The FASB has made recent improvements in how it writes accounting standards as part of its Understandability initiative and Codification project. We support the increased use of clearly-stated objectives, outcomes and principles in accounting standards that bring together this thinking. We believe the highest goal for accounting standards in the future is that they faithfully represent the economics of transactions and are responsive to investors' needs for clarity, transparency and comparability. Accounting standards that meet these criteria, when applied in good faith in a standards-setting system that employs the Committee's other proposals, will foster enhanced comparability and help to restore trust and confidence in financial reporting.

Although Subcommittee II supports increased use of objectives, outcomes and principles, the goal would not be to remove all rules. Rather, we agree with the notion that ideal accounting standards lay somewhere on the spectrum between principles-based and rules-based and that a framework may be helpful to consistently determine where on that

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[2] CEOs of the World's Six Largest Audit Networks, A Proposed Framework for Establishing Principles-Based Accounting Standards, Global Public Policy Symposium (January 2008).

spectrum new accounting standards should be written over time. This would assist the standards-setter in determining rules that might be necessary in certain circumstances. For example, if the standards-setter believes that there is only one way to reflect the economics of a transaction while promoting clarity, transparency and comparability for investors, it would be reasonable to provide prescriptive guidance in addition to objectives or principles.

Exhibit D

SEC Advisory Committee on Improvements to Financial Reporting
Audit Process and Compliance Subcommittee Update
May 2, 2008 Full Committee Meeting

I. Introduction

The SEC's Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.[1] In chapter 3 of the Progress Report, the Committee discussed its work-to-date in the area of audit process and compliance, namely, its developed proposals related to providing guidance with respect to the materiality and correction of errors; and judgments related to accounting matters.

Since the issuance of the Progress Report, the audit process and compliance subcommittee (Subcommittee III) has received a considerable amount of public comment regarding the developed proposals included in the Progress Report. This public input includes feedback obtained during the panel discussions regarding the developed proposals in Chapter 3 of the Progress Report held during Committee's March 13 open meeting, feedback obtained when certain members of the subcommittee met with the PCAOB Standing Advisory Group (SAG) on February 27, 2008, feedback obtained when the subcommittee met with market participants at our subcommittee meetings and the numerous comment letters received by the Committee. Based on this considerable public feedback, Subcommittee III believes that there are several areas related to the Committee's original developed proposals that warrant clarification by the Committee as well as some additional items that need to be considered by the Committee. This report

[1] Refer to Progress Report at http://www.sec.gov/rules/other/2008/33-8896.pdf.

Topic 1M is appropriate and accomplishes what it was intended to do, which is to address situations where errors were not being evaluated for materiality simply due to the relatively small size of the error. As the SEC staff noted in SAB 99, this concept was not consistent with the total mix standard established by the Supreme Court. SAB Topic 1M was not written to address all situations one must consider when determining if an error is material, yet in practice, SAB Topic 1M is often cited as the guidance to use in all materiality decisions. Because SAB Topic 1M primarily addresses one issue, which was to correct the misperception in practice at the time that small errors need not be evaluated for materiality solely based on their size, Subcommittee III believes that this has resulted in less consideration to the total mix of information in the evaluation of whether an error is material or not. Since this is not consistent with the standard established by the Supreme Court or as we understand it the intent of SAB Topic 1M, Subcommittee III believes that additional guidance is needed to supplement the guidance contained in SAB Topic 1M.

Second, there have been some additional studies of restatements that have been published since the issuance of the Progress Report. The most significant study is the study commissioned by the U.S. Treasury entitled "The Changing Nature and Consequences of Public Company Financial Restatements 1997-2006", conducted by Professor Susan Scholz of the University of Kansas. Subcommittee III believes that the results of this study are not inconsistent with the developed proposals in the Committee's Progress Report.

Third, Subcommittee III believes clarifications are needed related to the use of the term current investor in the Progress Report. Some have concluded that this term only refers to investors who currently own securities of a company. Subcommittee III did not intend the Committee's developed proposal to convey such a narrow definition of current investor, so there are proposed edits to the developed proposal to reflect that the correction of an error should be based on the needs of all investors making current investment decisions.

Fourth, there were several public comments related to the use of the term "sliding scale" in the developed proposals in the Progress Report. Many of these comments were concerned that this term was confusing and did not help explain the principles in the developed proposal. Subcommittee III does not believe that the use of this term is critical to the principles articulated in the developed proposals in the Progress Report. Therefore Subcommittee III proposes to remove the use of this term in the developed proposals.

Finally, because Subcommittee III believes that issues related to the dark period, most notably the potential high cost to investors during the dark period, are very important, a new developed proposal is being recommended by the subcommittee to highlight the importance of this issue. This new developed proposal contains substantially the same wording that was included in the Progress Report, but has been moved to give more prominence to this important issue.

III. Judgment

Similar to the reaction to the Committee's developed proposals related to restatements in the Progress Report (Developed Proposals 3.1, 3.2 and 3.3), there has been much public comment related to the Committee's developed proposal 3.4 in the Progress Report related to professional judgment. Subcommittee III believes that the comments it has received during this process have been very helpful to its continuing deliberations on this matter. Based on the comments received, Subcommittee III believes that some changes are necessary to the developed proposal 3.4 in the Progress Report to allow the developed proposal to meet the goals established in that Progress Report without the risks that the subcommittee has been concerned about from the beginning, such as the risk that the developed proposal devolve into a checklist based approach to making judgments and the risk that the proposed framework could be used as a shield to protect unreasonable judgments.

The primary change that Subcommittee III believes should be made is to refocus the developed proposal away from a recommendation for a framework. While Subcommittee III believes that there is great merit in the idea of a framework, the term framework can imply a mechanistic process. Making and evaluating judgments can involve a process, but the notion of a process is dangerous because it implies that an outcome can be achieved. Indeed, no matter how robust a process one uses to make judgments, there can be no guarantee that the outcome will be reasonable. Instead, Subcommittee III believes that a preferable way to accomplish the goals set forth in the Progress Report would be to have the SEC formally articulate in a statement of policy how the SEC evaluates judgments, including the factors that it uses as part of its evaluation. Therefore, Subcommittee III believes the developed proposal should be changed to formally propose such as statement of policy to be issued.

Some commenters have stated that developed proposal 3.4 in the Progress Report advocates a safe harbor be established for the exercise of professional judgment. Subcommittee III did not intend to advocate any particular way for the implementation of developed proposal 3.4. Instead, this decision was left to the SEC. With the change in focus outlined above, Subcommittee III believes that a statement of policy would be the preferred way to implement the revised proposal and therefore, there should be no reference to a safe harbor in the revised Chapter 3.

Subcommittee III also proposes to remove the use of the term professional when referring to judgment. Subcommittee III believes that there could be a misunderstanding that the term professional implies that one must have a professional certification in order to make or evaluate a professional judgment. While Subcommittee III believes that such professional certifications are important, it did not intend to suggest such a requirement for the application or evaluation of accounting judgments.

Appendix A

Subcommittee III has included as Appendix A to this update a revised version of Chapter 3 from the Progress Report that reflects the proposed edits for the Committee's consideration

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 materiality and misinterpretations of the existing guidance regarding materiality in SAB 99, Materiality (as codified in SAB Topic 1M). SAB Topic 1M was written to primarily address a specific issue, when seemingly small errors could be material due to qualitative factors, however, the guidance in SAB Topic 1M is often utilized in all materiality decisions. As a result of this overly broad application of SAB Topic 1M, errors may have been deemed to be material when an investor[5] 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. When material errors occur, however,

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[4] U.S. Government Accountability Office (GAO) study, Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates (March 2007), and Audit Analytics study, 2006 Financial Restatements A Six Year Comparison (February 2007).

[5] We use the term investor to include all people using financial statements to make investment decisions.

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.[6] We believe that public companies should focus on reducing errors in financial statements. At the same time, we believe that some of our developed proposals in the areas of substantive complexity, as discussed in chapter 1, and the standards-setting process, as discussed in chapter 2, 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 restatements that do not provide important information to investors making current investment decisions. Restatements can be costly for companies and auditors, may reduce confidence in reporting, and may create confusion that reduces the efficiency of investor analysis. This portion of this chapter describes our proposals regarding: (1) additional guidance on the concept and application regarding materiality, and (2) the process for and disclosure of the correction of errors.

[6] A Glass Lewis & Co. report, The Tide is Turning (January 15, 2008), shows that restatements in companies subject to section 404 of the Sarbanes Oxley Act have declined for two consecutive years.

statement, and the trend toward restatements in cases where there is no evidence of fraud or intentional wrongdoing[10]. Also, while there is recent evidence[11] that the number of restatements has declined in 2007, we note that the total number of restatements is still significant. We, therefore, believe supplementing existing guidance on determining whether an error is material and providing additional guidance on when a restatement is necessary for certain types of errors, would be beneficial in reducing the frequency of restatements that do not provide important information to investors making current investment decisions.

We have also considered input from equity and credit analysts and others about investors' views on materiality and how restatements are viewed in the marketplace. Feedback we have received 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.
- 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 in connection with restatements is not consistently adequate to allow an investor to evaluate the likelihood of errors in the future. Notably,

[10] These trends are addressed in Professor Scholz's study.
[11] Glass Lewis & Co. report, The Tide is Turning (January 15, 2008) indicates that approximately 1 out of every 11 public companies had a restatement during 2007.

<u>Developed Proposal 3.1:</u> The FASB or the SEC, as appropriate, should supplement existing guidance to reinforce the following concepts:

- **Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor.**
- **Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor.**

Just as qualitative factors may lead to a conclusion that a small error is material, qualitative factors also may lead to a conclusion that a large error is not material.

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

The Supreme Court has established that "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." We believe 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. We believe 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.

We believe that the current materiality guidance in SAB Topic 1M is appropriate in making most materiality judgments; We believe that, in current practice, however, this materiality guidance is being interpreted generally as being one-directional, that is, as providing that qualitative considerations can result in a small error being considered material, but that a large error is material without regard to qualitative factors. This one-directional interpretation is not consistent with the standard established by the Supreme Court, which requires an assessment of the total mix of information available to the investor making an investment decision. We believe that, in general, qualitative factors not only can increase, but also can decrease, the importance of an error to the reasonable investor, although we acknowledge that there will probably be more times when qualitative considerations will result in a small error being considered material than they will result in a large error being considered not to be material[13]. Therefore, we recommend that the existing materiality guidance be enhanced to clarify that the total mix of information available to investors should be the main focus of a materiality judgment and that qualitative factors are relevant in analyzing the materiality of both large and small errors. We view this recommendation as a modest clarification of the existing guidance to conform practice to the standard established by the Supreme Court and not a

[13] Some have argued that, under such guidance, a very large error that affects meaningful financial statement metrics could be deemed immaterial by virtue of qualitative factors. The Committee believes that when one focuses on the total mix of information, the probability of this situation occurring is remote.

wholesale revision to the concepts and principles embedded in existing SEC staff guidance in SAB Topic 1M.

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 considered a "checklist" whereby the presence of any one of these items would make an error not material. Companies and their auditors should continue to look at the totality of all factors when making a materiality judgment):

- The error impacts metrics that do not drive investor conclusions or are not important to 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.

Finally, we recommend that the enhanced guidance suggest some factors that are relevant to the analysis of errors in the cash flow statement and the balance sheet. We note that the existing guidance suggests factors that are relevant primarily to the analysis of the materiality of an error in the income statement.

Internal education and external 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 toward reducing restatements that do not provide useful information to investors.

<u>Developed Proposal 3.2:</u> The FASB or the SEC, as appropriate, should issue guidance on how to correct an error consistent with the principles outlined below:

- **All errors, other than clearly insignificant errors, should be promptly corrected no later than in the financial statements of the period in which the error is discovered. All material errors should be disclosed when they are corrected.**
- **Prior period financial statements should only be restated for errors that are material to those prior periods.**
- **The determination of how to correct a material error should be based on the needs of current investors. For example, a material error that has no relevance to a current investment decision would not require amendment of the annual financial statements in which the error occurred, but would need to be promptly corrected and disclosed 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 statement, 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.**
- **Corrections of large errors should always be disclosed, even if the error was determined not to be material.**

We believe that all errors, excluding clearly insignificant errors, should be corrected no later than in the financial statements of the annual or interim period in which the error is discovered. The correction of errors, even errors that are not material, should not be deferred to future periods. Rather, companies should be required to correct all errors promptly and make appropriate disclosures about the correction, particularly when the errors are material, and should not have the option to defer recognition of errors until future financial statements. Notwithstanding the foregoing, immaterial errors discovered shortly before the issuance of the financial statements may not need to be corrected until the next annual or interim period being reported upon when earlier correction is impracticable.[14]

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 occurring 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. By correcting small errors when they are identified, a company will eliminate the possibility that the continuation of the error over a period of time will result in the total amount of the error becoming material to a company's financial statements and requiring correction at that time. Newly discovered errors that had occurred over a period of time when they were not material, however, would still trigger the need for correction. In the

[14] We understand 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.

process of reflecting these immaterial corrections to prior annual periods, some believe that the prior annual period financial statements should indicate that they have been restated. There is diversity in practice on this issue, and clarification is needed from the SEC on the intent of SAB Topic 1N. We believe that prior annual period financial statements should not be restated for errors that are immaterial to the prior annual period. Instead of the approach specified in Topic 1N, we believe 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 period[15] with appropriate disclosure at the time the current annual period financial statements are filed with the SEC.

We believe that the determination of how errors should be corrected should be based on the needs of investors making current investment decisions. This determination should take into account the facts and circumstances of each error. For example, a prior period error that was material to that prior period but that does not affect the annual financial statements or financial information included within a company's most recent filing with the SEC may not need to be corrected through an amendment to prior period filings if the financial statements that contain the error are determined to be irrelevant to investors making current investment decisions. Such errors would be corrected in the period in which they are discovered with appropriate disclosure about the error and the periods

[15] We are 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 of errors that are not material to prior periods could be accomplished through an adjustment to equity or to current period income (which might potentially require an amendment to GAAP). We believe that there are merits in both approaches and that the FASB and the SEC, as appropriate, should carefully weigh both approaches before determining the actual approach to utilize.

impacted. This approach provide investors making current investment decisions with more timely financial reports and avoid the costs to investors of delaying prompt disclosure of current financial information in order for a company to correct multiple prior filings.

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 with appropriate disclosure of the error and its impact on prior periods, instead of amending previous filings with the SEC. This option should be further studied with regard to the possibility of abuse and, if appropriate, should be included in the overall guidance on how to correct errors.

Assuming that there is an error in an interim period within an annual period for which financial statements have previously been filed with the SEC, 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 be material only 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 Form 10-K should not be amended). However, there should be appropriate disclosure in the company's next Form 10-K to explain the

discrepancy in the results for the interim periods during the previous annual period on an aggregate basis and the reported results for that annual period.

We believe that investors should be informed about all large errors when they are corrected. Even if a large error is determined to be not material because of qualitative factors, there should be appropriate disclosure about the error in the period in which the error is corrected.

We believe that the issuance by the FASB or the SEC, as appropriate, of guidance on how to correct and disclose errors in previously issued financial statements will provide to investors higher quality and more timely information (e.g., less delay occasioned by the need for restatement of prior period financial statements for errors that are not material and for errors that have no relevance to investors making current investment decisions) and reduce the burdens on companies related to the preparation of amended reports. Since our proposal would require prompt correction and full disclosure about all material errors, all large errors that are considered to be not material as well as many other types of errors, it would enhance transparency of accounting errors and help to eliminate the phenomenon of so called "stealth restatements" – when an error impacts past financial statements without disclosure of such error in current financial filings.

Developed Proposal 3.3: **The FASB or the SEC, as appropriate, should issue guidance on disclosure during the period in which the restatement is being**

prepared, about the need for a restatement and about the restatement itself, to improve the adequacy of this disclosure based on the needs of investors:

Typically, the restatement process involves three primary reporting stages:

1. The initial notification to the SEC and investors that there is a material error and that the financial statements previously filed with the SEC can no longer be relied upon;
2. The "dark period" or the period between the initial notification to the SEC and the time restated financial statements are filed with the SEC; and
3. The filing of restated financial statements with the SEC.

We believe that a major effect on investors due 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 decreases in the company's stock price. In addition, delays in filing restated financial statements may create default conditions in loan covenants; these delays may adversely affect the company's liquidity. We understand that, in the current legal environment, companies are often unwilling to provide disclosure of uncertain information. However, we believe that when companies are going through the restatement process, they should be encouraged to continue to provide any reasonably reliable financial information that they can, accompanied by appropriate explanations of ways in which the information could be affected by the restatement. 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.

We believe that the current disclosure surrounding a restatement is often not adequate to allow investors to evaluate the company’s operations and the likelihood that such errors could occur in the future. Specifically, we believe 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
- Material items in each of the financial statements subject to the error 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, and 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, and other consequences of the restatement

If there are material developments related to the restatement, companies should update this disclosure on a periodic basis during the restatement process, particularly when quarterly or annual reports are required to be filed, and provide full and complete disclosure within the filing with the SEC that includes the restated financial statements.

<u>**Developed Proposal 3.4:**</u> **The FASB or the SEC, as appropriate, should develop and issue guidance on applying materiality to errors identified in prior interim periods and how to correct these errors. This guidance should reflect the following principles:**

- **Materiality in interim period financial statements must be assessed based on the perspective of the reasonable investor**

- **When there is a material error in an interim period, the guidance on how to correct that error should be consistent with the principles outlined in developed proposal 3.2.**

Based on prior 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.[16] 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, and also impacts investors, who can be confused by the inconsistency between how companies evaluate and report errors. We believe that guidance as to how to evaluate errors related to interim periods would be beneficial to preparers, auditors and investors.

We have 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, we believe 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

[16] Paragraph 29 of APB Opinion No. 28, Interim Financial Reporting, states the following:

> 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.

statements? and (2) How should errors in previously issued interim financial statements be corrected? We believe that additional guidance on these questions, which are extensions of the basic principles outlined in developed proposals 3.1 and 3.2 above, would provide useful guidance in assessing and correcting interim period errors. We believe that while these principles would assist in developing guidance related to interim periods, additional work should also be performed to fully develop robust guidance regarding errors identified in interim periods.

We believe 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.

We believe 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.

We also note 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.

III. Judgment

III.A. Background

Overview

Judgment is not new to the areas of accounting, auditing, or securities regulation – the criteria for making and evaluating judgment have been a topic of discussion for many years. The recent increased focus on 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. Investors will benefit from more emphasis on "principles-based" standards, since "rules-based" standards (as discussed in chapters 1 and 2) may provide a method, such as through exceptions and bright-line tests, to avoid the accounting objectives underlying the standards. If properly implemented, "principles-based" standards should improve the information provided to investors while reducing the investor's concern about "financial engineering" by companies using the "rules" to avoid accounting for the substance of a transaction. While preparers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by regulators in evaluating judgments does not provide an environment in which 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 preparers 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 may attempt to inappropriately defend certain errors as "reasonable judgments." Identifying standard processes for making judgments and criteria for evaluating those judgments, after the fact, may provide an environment that promotes the use of judgment and encourages consistent evaluation practices among regulators.

<u>Goals of Potential Guidance on Judgments</u>

The following are several issues that any potential guidance related to judgments may help address:

a. Investors' lack of confidence in the use of judgment – Guidance on judgments may provide investors with greater comfort that there is an acceptable rigor that companies follow in exercising reasonable judgment.

b. Preparers' concern regarding whether reasonable judgments are respected – In the current environment, preparers may be afraid to exercise judgment for fear of having their judgments overruled, after the fact by regulators.

Further, 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.

For example, opinions on the appropriate standard to account for loan losses or to measure impairments of assets typically do not differ. However, the assumptions and methodology used by management to actually determine the allowance for loan losses or to determine an impairment of an asset can be a highly judgmental area.

The use of hindsight to evaluate a 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, <u>or should have been known</u>,[17] 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 on the facts reasonably available at the time the annual or interim financial statements were issued.

<u>Form of Potential Guidance</u>

We believe that there are many different ways that potential guidance on judgment could be provided. To be successful, however, we believe that guidance on judgment should not eliminate debate, nor be inflexible or mechanical in application. Rather, the guidance should encourage preparers to organize their analysis and focus preparers and others on areas to be addressed; thereby improving the quality of the judgment and likelihood that regulators will accept the judgment. Any guidance issued should be designed to stimulate a rigorous, thoughtful and deliberate process rather than a checklist-based approach for making and evaluating judgments.

One potential way to accomplish the goals we set forth earlier as well as to guard against the potential that such guidance would develop into a checklist-based approach is for the

[17] We believe that those making a judgment should be expected to exercise due care in gathering all of the relevant facts prior to making the judgment.

SEC to formally state its approach to evaluating judgments. As discussed earlier in this report, one of the major concerns surrounding the use of judgment is the possibility of a regulator “second guessing” the reasonableness of a judgment after the fact. We believe that a primary cause of this concern is a lack of clarity and transparency into the process the SEC uses to evaluate the reasonableness of judgments. The SEC has articulated its policies in the past with success. Examples of previous articulations of policy by the SEC include the “Seaboard” report (October 23, 2001) relating to the impact of a company’s cooperation on a potential SEC enforcement case and the SEC’s framework for assessing the appropriateness of corporate penalties (January 4, 2006). We believe that a statement of policy could implement the goals we have articulated and therefore recommend that the SEC and the PCAOB issue statements of policy describing how they evaluate the reasonableness of accounting and auditing judgments.

The Nature and Limitations of GAAP:

Some have suggested that potential judgment guidance for the selection and implementation of GAAP be a requirement to reflect the economic substance of a transaction or be a standard of selecting the "high road" in accounting for a transaction. We agree that qualitative standards for GAAP such as these would be desirable and we encourage regulators and standards-setters to move financial reporting in this direction. However, such standards are not always present in financial reporting today and we cannot recommend the articulation of such standards in an SEC statement of policy 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, and a less preferable alternative is fully acceptable absent such a change.

We believe that adopting a requirement that accounting judgments reflect economic substance or the "high road" would require a revolutionary change not achievable in the foreseeable future. Our suggestion that the SEC issue a statement of policy relating to its evaluation of judgments could and we believe would enhance adherence to GAAP, but it cannot be expected to correct inherent weaknesses in the standards to which it would be applied.

III.B. Developed Proposals

We have developed the following proposal:

Developed Proposal 3.5: The SEC should issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. The PCAOB should also adopt a similar approach with respect to auditing judgments.

The statement of policy applicable to accounting-related judgments should address the choice and application of accounting principles, as well as estimates and evidence related to the application of an accounting principle. We believe that a statement of policy that is consistent with the principles outlined in this developed proposal to cover judgments made by auditors based on the application of PCAOB auditing standards would be very beneficial to auditors. Therefore, we propose that the PCAOB develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. The PCAOB statement of policy should acknowledge that the

PCAOB would look to the SEC's statement of policy to the extent the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.

We believe that it would be useful if the SEC also set forth in the statement of policy factors that it looks to when evaluating the reasonableness of preparers accounting judgments.

<u>The Concept of Judgment in Accounting Matters</u>

Judgment, with respect to accounting matters, should be exercised by a person or persons who have the appropriate level of knowledge, experience, and objectivity and form an opinion based on the relevant facts and circumstances within the context provided by applicable accounting standards. Judgments could differ between knowledgeable, experienced, and objective persons. Such differences between reasonable 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.

We have listed below various factors that we believe preparers should consider when making accounting judgments. The SEC may want to take these factors into account in developing its statement of policy. We also believe that a suggestion by the SEC that preparers should carefully consider these factors when making accounting judgments would be beneficial in not only increasing the quality of judgments, but also in making sure that the SEC and preparers will be able to more efficiently resolve potential differences during the SEC's review of preparer's filings. The mere consideration by a preparer of these factors in a SEC statement of policy would not prevent a regulator from asking appropriate questions about the accounting judgments made by the preparer or asking companies to correct unreasonable judgments, however. In fact, there is no guarantee that the preparer's consideration of the SEC's suggested factors articulated in a statement of policy would result in a reasonable judgment being reached. Rather, the statement of policy should be designed to encourage preparers to organize their analysis and focus preparers and others on areas that would be the focus of the SEC's review, thereby improving the quality of the judgment and likelihood that regulators will accept the judgment. We encourage the SEC to seek to accept a range of alternative reasonable judgments when preparers make good faith attempts to reach a reasonable judgment. A preparer's failure to follow the SEC's suggested factors in its statement of policy, however, would not imply that the judgment is unreasonable.

We would expect that, in the evaluation of judgments made using the factors that are cited below, the focus would be on significant matters requiring judgment that could have a material effect on the financial statements taken as a whole. We recognize that the facts and circumstances of each judgment may indicate that certain factors are more important than others. These factors would have a greater influence in an evaluation of the reasonableness of a judgment made by a preparer.

Factors to Consider when Evaluating the Reasonableness of a Judgment

While we believe that the SEC should articulate the factors that it uses when evaluating the reasonableness of a judgment, we believe that the statement of policy would be even more useful to preparers if the SEC also made suggestions for ways in which accounting judgments could be made.

We believe that accounting judgments should be based on a critical and reasoned evaluation made in good faith and in a rigorous, thoughtful and deliberate manner. We believe that preparers should have appropriate controls in place to ensure adequate consideration of all relevant factors. Factors applicable to the making of an accounting judgment include the following:

1. The preparer's analysis of the transaction, including the substance and business purpose of the transaction
2. The material facts reasonably available at the time that the financial statements are issued
3. The preparer's review and analysis of relevant literature, including the relevant underlying principles

4. The preparer's analysis of alternative views or estimates, including pros and cons for reasonable alternatives
5. The preparer's rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties
6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated
7. The level of input from people with an appropriate level of professional expertise[18]
8. The preparer's consideration of known diversity in practice regarding the alternatives or estimates[19]
9. The preparer's consistency of application of alternatives or estimates to similar transactions
10. The appropriateness and reliability of the assumptions and data used.
11. The adequacy of the amount of time and effort spent to consider the judgment.

When considering these factors, it would be expected that the amount of documentation, disclosure, input from professional experts, and level of effort in making a judgment would vary based on the complexity, nature (routine versus non-routine) and materiality of a transaction or issue requiring judgment.

[18] In many cases, input from professional experts would include consultation with a preparer's independent auditors or other competent external parties, such as valuation specialists, actuaries or counsel
[19] If there is not diversity in practice, it would be significantly harder to select a different alternative.

Material issues or transactions should be disclosed appropriately. We note that existing disclosure requirements should be sufficient to generate[20] transparent disclosure that enables an investor to understand the transaction and assumptions that were critical to the judgment. The SEC has provided in the past, and should continue to consider providing, additional guidance on existing disclosure requirements to encourage more transparent disclosure. In addition, when evaluating the reasonableness of a judgment, 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 complicate an explanation of the nature and propriety of a judgment made at the time of the release of the financial statements.

[20] Existing disclosure requirements would include the guidance on critical accounting estimates in the Commissions Release No. 33-8350 “Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, the Commissions Release No. 33-8040 “Cautionary Advice Regarding Disclosure About Critical Accounting Policies” and Accounting Principles Board Opinion No. 22 “Disclosure of Accounting Policies”. We also encourage the SEC to continue to remind preparers of ways to improve the transparency of disclosure, such as through statements like the Sample Letter sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) issued by the Division of Corporation Finance in March 2008.

Exhibit E

SEC Advisory Committee on Improvements to Financial Reporting
Delivering Financial Information Subcommittee Update
May 2, 2008 Full Committee Meeting

I. Introduction

The SEC's Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.[51] In chapter 4 of the Progress Report, the Committee discussed its work-to-date in the area of delivering financial information including its developed proposals relating to XBRL tagging of financial information and improved use of corporate websites and its future considerations relating to disclosure of key performance indicators, improved quarterly press release disclosures and timing, and the inclusion of executive summaries in public company periodic reports.

Since the issuance of the Progress Report, the delivering financial information subcommittee (Subcommittee IV) has deliberated further the areas of improved use of corporate websites, disclosure of key performance indicators, improved quarterly press release disclosures and timing and inclusion of executive summaries. This report represents Subcommittee IV's latest thinking, including its consideration of input received through comment letters and received orally at the March 14, 2008 Committee meeting in San Francisco and subsequent Subcommittee meeting with industry participants. Subject to further public comment, Subcommittee IV will recommend the following preliminary hypotheses to the full Committee for its consideration in developing the final report, which it expects to issue in July 2008.

II. XBRL

[51] Refer to Progress Report at http://www.sec.gov/rules/other/2008/33-8896.pdf.

In the Progress Report, the Committee issued a developed proposal regarding XBRL (developed proposal 4.1). Refer to the Progress Report for additional discussion of this developed proposal. At the Committee meeting on March 14, 2008 held in San Francisco, the Committee received oral and written input from market participants regarding the XBRL developed proposal. The Subcommittee understands the SEC has scheduled an open meeting on May 14, 2008 to consider whether to propose amendments to provide for corporate financial statement information to be filed with the SEC in interactive data format, and a near- and long-term schedule therefore. Subcommittee IV proposes no revisions at this time to the developed proposal.

III. Use of Corporate Websites

In the Progress Report, the Committee issued a developed proposal regarding the use of corporate websites and the development of uniform best practices regarding corporate website use by industry participants (developed proposal 4.2). Refer to the Progress Report for additional discussion of this developed proposal. The Committee heard additional input from industry participants, including newswire services, reporting companies, investors, and securities lawyers regarding the developed proposal as part of the comments received on the Progress Report. The Subcommittee heard from companies and investors about the value of corporate website disclosures as an additional, though not exclusive, means of providing information to the market in a timely manner available to all persons. Subcommittee IV proposes no significant revisions at this time to the developed proposals regarding corporate websites and industry developed best practice guidelines.

IV. Disclosures of KPIs and Other Metrics to Enhance Business Reporting

Preliminary Hypothesis 1:

The SEC should encourage private sector initiatives targeted at best practice development of company use of Key Performance Indicators (KPIs) in their business reports. The SEC should encourage private sector dialogue, involving preparers, investors, and other interested industry participants, such as consortia that have long supported KPI-like concepts, to generate understandable, consistent, relevant and comparable KPIs on an industry-specific and relevant activity basis. The SEC also should encourage companies to provide, explain, and consistently disclose period-to-period company-specific KPIs. The SEC should consider reiterating and expanding its interpretive guidance regarding disclosures of KPIs in MD&A and other company disclosures.

The Committee should further acknowledge the useful work of those consortia that endeavour to go beyond the limited scope of the Committee's recommendation to provide an overall structure which provide a linking of financial and KPI indicators into a seamless whole.

Background:

As the Committee noted in the Progress Report, enhanced business reporting and key performance indicators (KPIs) are disclosures about the aspects of a company's business that provide significant insight into the sources of its value. The Enhanced Business Reporting Consortium,[52] has stated that the value drivers for a business "can be measured numerically through KPIs 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 include supplemental non-GAAP financial reporting disclosures that proponents have stated can improve disclosures by public companies. Such KPIs also may include non-financial measures. KPIs are leading indicators of financial results and intangible assets that are not necessarily encompassed on a company's balance sheet and can provide more transparency and understanding about the company to investors. Proponents of the use of KPIs 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. Managers and boards of directors of companies 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.

The Committee understands that investment professionals concur that investors are very interested in non-financial information as a way to better understand the businesses they invest in. They recognize that financial reports provide an accounting of past events and a current view of the financial condition of the company. The financials are viewed as an end of process result delivered as a combination of market conditions and company business strategies, processes and execution.

[52] 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.

The financials are, by their nature, not necessarily forward-looking indicators. Of interest to many investors from a business reporting standpoint is information regarding the fundamental drivers of the business and metrics used to give evidence as to how the business is being managed in the environment it finds itself in. Financial reporting captures some aspects of this but not all and, in fact, financial statements are not currently designed to provide a broader picture of the company and its operations.

From a corporate preparer standpoint, management uses KPIs as key metrics with which to direct the company as part of the strategic planning process both in terms of goal setting and as a way to provide analysis and feedback. In that regard the degree to which companies are comfortable sharing these metrics with shareholders, communication would be greatly enhanced. By its very nature such communication would increase the fundamental transparency of the business. Numerous prior studies have shown that greater transparency on the part of corporations reduces the company's cost of capital and no doubt improves market efficiency.

Recognizing this, the SEC encourages extensive discussion of the condition of the business in the MD&A. The SEC, in its 2003 MD&A Interpretive Release, stated the "[o]ne of the principal objectives of MD&A is to give readers a view of the company through the eyes of management by providing both a short and long-term analysis of the business. To do this, companies should 'identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company'." In this regard, the SEC noted the importance of disclosures of key performance measures - "when preparing MD&A, companies should consider whether disclosure of all key variables and other factors that management uses to manage the business would be material to investors, and therefore required. These key variables and other factors may be non-financial, and companies should consider whether that non-financial information should be disclosed." The SEC went on to state that "[i]ndustry-specific measures can also be important for analysis, although common standards for the measures also are important. Some industries commonly use non-financial data, such as industry metrics and value drivers. Where a company discloses such information, and there is no commonly accepted method of calculating a particular non-financial metric, it should provide an explanation of its calculation to promote comparability across companies within the industry. Finally, companies may use non-financial performance measures that are company-specific."[53] This discussion is intended to give information about the business in a way that is consistent with the manner in which the business is run.

Discussion:

The Subcommittee's hypothesis extends beyond a narrow definition of financial reporting to business reporting more generally. The Subcommittee has been evaluating whether public companies should increase their voluntary disclosure of financial and non-financial performance measures or indicators, such as KPIs. The Subcommittee has examined the current practices of public companies and notes that many companies are already disclosing some company-specific KPIs in their periodic reports filed with the SEC or in other public statements, but these company-specific measures may not necessarily be consistently reported by companies from period-to-period, are not necessarily well-defined, and may not be commonly used by other companies in the

[53] SEC, Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 33-8350 (December 19, 2003) (2003 MD&A Interpretive Release).

same industry so that they lend themselves to comparisons between and among companies. Therefore, as part of its review of KPI disclosure, the Subcommittee has evaluated the kinds of KPIs that should be made available, in what format, and whether they should be consistently defined over time. The Subcommittee has found that various groups, within and outside industries, are working on developing industry-specific and activity-specific KPIs in order to improve comparability of companies on an industry basis.

In developing its preliminary hypothesis on KPIs and other possible metrics to enhance business reporting, the Subcommittee consulted with industry members and others who have been working on this subject. As a result of these discussions and its evaluation of other materials, the Subcommittee preliminarily believes that further exploration of the use of KPIs and other metrics by public companies would be constructive.

Accordingly, for KPI reporting to be most effective and improve user understanding, the Subcommittee is considering that the full Committee recommend that companies should consider the following to improve KPI disclosures.[54]

- Understandability – The Subcommittee believes that a given KPI term, such as "same store sales," would be most useful in evaluating the relevant industry or activity if it had a standard agreed definition in the industry. For that reason, as part of its preliminary hypothesis, the Subcommittee notes that the SEC should explore ways to encourage private

[54] The Subcommittee notes that the SEC has provided guidance as to some of these matters as well in its 2003 MD&A Interpretive Release as discussed above. The SEC noted that "[t]he focus on key performance indicators can be enhanced not only through the language and content of the discussion, but also through a format that will enhance the understanding of the discussion and analysis."

initiatives in various industries for the development of standard KPI definitions. It is presumed that there would be some terms that would be macro in nature that companies from all industries would make use of and thus would be activity-based, but it is assumed that many KPI terms would be industry-specific. Once a term has been defined by industry, the SEC and other global regulators should work with industry to support the use of such term in periodic and other company reports, with such modified or additional disclosures as the SEC and other global regulators deem necessary or appropriate. Companies should be encouraged to use such industry-defined terms and to disclose any differences in their use terms from any industry-defined and accepted definition. Companies would still have the freedom to use whatever terms they wished in describing their businesses but would be expected to make clear any differences between their definitions and those that have been industry-defined.

- Consistency – Whether or not a company uses an industry-defined term for its KPI disclosures, the KPI that is used should be reported consistently from period-to-period. Any changes in the definition of a KPI should be disclosed, along with the reasons for the change. KPIs should be reported not just for the current period but for prior periods as well so that investors can assess the company's development from period-to-period or year-to-year.

- Relevancy - KPI that are disclosed should be important to an understanding and tracking of the business or business segments for which they are used and should align with how reporting companies run their business.

- Presentability – When companies disclose KPIs in their reports and other releases, they should make clear to ordinary investors that the information is intended to provide information about the business of the company that is separate from and supplemental to the financial statements. This could either be done in a separate KPI section in MD&A or in subsections of parts of the MD&A, such as the general business discussion or the discussion by business segment. Segment reporting of KPIs, given the logical connection to business line activities, could be very useful. The inclusion of tabular presentations showing current and prior periods should be seriously considered.

- Comparability – Encouraging companies to use industry-defined KPI's would enable investors to compare companies within and across industries and would also be quite useful at the industry segment level. Once industry-defined KPIs are available, the Subcommittee would hope that investor interest would encourage companies to use commonly defined KPI terms.

The Subcommittee has heard that some companies may be hesitant about increased disclosure of KPIs because of concern that disclosure of these metrics may compromise competitive information.[55] Neither the Subcommittee nor investors want companies to give away the "crown jewels." The Subcommittee has also heard questions about the validity of many of such competitive harm claims, particularly where information is widely known within a particular industry. The Subcommittee has heard that there is already so much information about companies that disclosure of unique competitive information would be rare. Nevertheless, the Subcommittee

[55] The Subcommittee also heard a question as to the liability treatment of KPIs.

preliminarily believes that if a particular KPI could require the disclosure of competitively important information, the affected company could decline to disclose it.

In an ideal disclosure system, non-financial and financial indicators and elements would be presented within a cohesive framework that combines KPIs and other indicators with GAAP data and text discussion in order to create a complete a complete picture of a company. At this time, the Subcommittee believes that having the Committee propose to mandate or suggest such an organized structure is outside the scope of what the Subcommittee is evaluating, might be premature and inappropriate for a regulator or standard setter, possibly being too prescriptive.

Rather, the Subcommittee's preliminary hypothesis provides believes that the SEC should encourage an industry driven initiative with significant investor involvement to develop best practices that companies could follow in developing and disclosing KPIs. Just as financial reporting standards and the recently developed XBRL taxonomy may improve business reporting by creating standardized language, the Subcommittee believes the development of a KPI dictionary, developed on an industry basis but also allowing for company-specific definitions, also could provide valuable information to investors.

Thus, the Subcommittee has developed a preliminary hypothesis that is based on a number of industry-driven initiatives, with significant investor involvement, to develop best practices and common definitions for KPIs that companies could follow in disclosing KPIs. The hypothesis suggests that companies, investors, and business reporting consortiums should work together to develop industry-wide and activity-specific KPIs that conform to uniform or standard definitions, as well as company-specific KPIs. These KPIs should then be disclosed in a company's periodic reports, as well as other disclosure formats such as earnings releases. The hypothesis suggests that the KPIs:

- be clearly and consistently defined to allow investors understanding of the meanings of the KPIs;
- be disclosed, as relevant, on a company and/or segment basis; and
- permit cross-company and cross-industry comparisons.

The Subcommittee does not believe that the mandatory reporting of KPIs is desirable at this time. Instead, the Subcommittee believes that the Committee should consider encouraging the SEC to promote the development of commonly recognized and defined KPIs by industry groups.

Integration with Other Proposals:

The Subcommittee preliminarily believes that the formalization of KPI disclosures through commonly recognized definitions, will enhance the benefits that will come from other proposals from the Committee. For example, disclosing KPIs on company web sites would allow investors and other users of the reported information to gain an improved understanding of the prospects for a company and could lead to better capital market pricing.

V. Improved Quarterly Press Release Disclosures and Timing

Preliminary Hypothesis 2:

Industry groups, including the National Investor Relations Institute, FEI, and the CFA Institute should update their best practices for earnings releases. Such updated best practices guidance should cover, among other matters, the type of information that should be provided in earnings releases and the need for investors to receive information that is consistent from quarter to quarter, with an explanation of any changes in disclosures from quarter to quarter. Further, the best practices guidance should consider recommending that companies include in their earnings releases the income statement, balance sheet and cash flow tables, locate GAAP reconciliations in close proximity to any non-GAAP measures presented, and provide more industry and company specific key performance indicators.

The SEC should consider reinforcing its view that disclosures in connection with earnings calls posted on company websites should be maintained and available on such sites for at least 12 months.

Background:

As noted in the Progress Report, the quarterly earnings release, often the first corporate communication about the result of the quarter just ended, is viewed as an important corporate communication. This communication often receives more attention than the formal Form 10-Q submission which often occurs a week or two later.

The quarterly earnings release is not currently required to contain mandated information other than that required by the application of Regulation G to the presentation of non-GAAP measures and the antifraud provisions of the federal securities laws. Industry groups have previously coordinated in developing best practices for reporting companies to follow in preparing their earnings releases. In addition, under SEC rules, companies must furnish earnings releases to the Commission on a Form 8-K. Investors and other market participants have expressed concern about the matters relating to earnings releases, including consistency of information provided in such releases, the timing of such releases in relation to the filing of the applicable periodic report, and the inclusion of earnings guidance in such earnings releases.

Discussion:

The Subcommittee has been examining a number of issues relating to the earnings release, including with regard to its consistency, understandability, timeliness, and the continued public availability of earnings conference calls. The Subcommittee had an opportunity to discuss the quarterly earnings release and these related matters with investor and company representatives. In addition, the Subcommittee considered the consistent provision of income statement, balance sheet and cash flow tables in the quarterly earnings release as well as 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. The Subcommittee viewed the goal for the earnings release to be a consistent, reliable communication form that all investors can easily navigate.

The Subcommittee also briefly discussed the advisability of requiring the issuance of the earnings releases on the same day that the periodic report (e.g., Form 10-Q) is filed, in contrast to the current practice in which the earnings release often is issued before the periodic report is filed. The Subcommittee heard from company and investor representatives in this regard and took note of the comments that the SEC received in connection with a prior request for comment to tie the filing of the quarterly report to the issuance of an earnings release. The Subcommittee understood that the practices of companies in this regard may differ depending on the size of the company and the company's own disclosure practices. For example, the Subcommittee understands that some large companies issue their earnings release at the same time as the filing of their quarterly reports. The Subcommittee also heard that smaller companies tended to wait to issue their earnings releases so that their news would not be eclipsed by news of larger and more well followed companies. While investors noted an interest in having the earnings release issued at the same time as the Form 10-Q is filed to avoid duplication of effort in analyzing the company's disclosures, representatives of companies and others expressed concern about the effect of delays in disclosing material non-public information about the quarter or year end. Investors also expressed concern regarding the trading of company stock by executives after the issuance of the earnings release but before the filing of the Form 10-Q and questioned whether executives could be prohibited from engaging in trading until after the Form 10-Q was filed.

The Subcommittee determined not to include a preliminary hypothesis that would change current market practice regarding the issuance of earnings releases but would suggest that, instead, the SEC monitor company practices in regard to the timing of the earnings release in relation to the filing of the relevant periodic report with the SEC.

The Subcommittee also heard concerns that companies were not keeping their earnings calls and related information posted on their websites for more than one quarter after the call, thus making quarterly comparisons difficult. The Subcommittee noted that the SEC had suggested that companies keep their website disclosures regarding GAAP reconciliations for non-GAAP measures presented on earnings calls available on their websites for at least a 12-month period and the Subcommittee's preliminary hypothesis would suggest that the SEC reiterate this guidance.[56]

The Subcommittee briefly discussed the practices of some companies in providing earnings guidance or public projections of next quarter's earnings by company officials, since some believe that this practice is an important underlying source of reporting complexity and other accounting problems. The Subcommittee also discussed the provision of annual guidance that may be updated quarterly. The Subcommittee does not intend to continue its evaluation of quarterly earnings guidance or to suggest any preliminary hypothesis regarding the provision of quarterly earnings guidance at this time because it notes that many others are evaluating the issues arising from the provision of quarterly earnings guidance.

VI. Use of Executive Summaries in Exchange Act Periodic Reports

Preliminary Hypothesis 3:

The SEC should mandate the inclusion of an executive summary in the forepart of a reporting company's filed annual and quarterly reports. The executive summary should

[56] See SEC Conditions for Use of Non-GAAP Measures, Exchange Act Release No. 34-47226 (Jan. 22, 2003).

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 the MD&A, the executive summary should be required to 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 requirement for the executive summary should build on the company's MD&A overview and essentially be principles-based, other than a limited number of required disclosure items such as:

- **A summary of a company's current financial statements;**
- **A digest of the company's GAAP and non-GAAP KPIs (to the extent disclosed in the company's 10-Q or 10-K);**
- **A summary of key aspects of company performance;**
- **A summary of business outlook;**
- **A brief description of the company's business, sales and marketing; and**
- **Page number references to more detailed information contained in the document (which, if the report is provided electronically, could be hyperlinks) .**

Background:

Reporting companies are not currently required to include any type of summary in their periodic reports, although a summary of the company and the securities it is offering is a line-item disclosure in Securities Act registration statements. Companies, therefore, are familiar with the concept of summarizing the important aspects of their business and operations at the time they are raising capital. The Subcommittee has heard that retail investors find it difficult at times to navigate through a company's periodic reports, including its Form 10-K annual report. The Subcommittee has been evaluating the use of an executive summary in the forepart of a company's annual and quarterly Exchange Act reports to facilitate the ready delivery of important information to investors by providing them a roadmap of the disclosures contained in such reports.

Discussion:

The Subcommittee 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 Subcommittee has met with investor and company representatives as well as securities counsel. The Subcommittee understands that a summary report prepared on a stand-alone basis would not necessarily provide investors with information they need in a desired format and that investors would not use such a summary. However, the Subcommittee understands that an executive summary included in the forepart of an Exchange Act periodic report may provide investors, particularly retail investors, with an important roadmap to the company's disclosures located in the body of such a report.[57] 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 the 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

[57] Such reports generally are posted on company websites as well so that the executive summaries would be electronically available with hyperlinks to the more detailed information in the relevant report.

reporting company and include cross-references to the location of the fuller discussion in the annual report.

As noted in the Progress Report and as contemplated in the Subcommittee's preliminary hypothesis, the goal of the executive summary would be to help investors fundamentally understand a company's 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 investors, with 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 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.

The executive summary in a periodic report should be brief, and it might fruitfully build on the overview that the SEC has identified should be in the forepart of the MD&A disclosure. The MD&A overview is expected to "include the most important matters on which a company's executives focus in evaluating the financial condition and operating performance and provide context."[58] The executive summary should build on the MD&A overview disclosure and include the following:

1. A summary of a company's current financial statements

[58] See 2003 MD&A Interpretive Release above.

2. A digest of the company's GAAP and non-GAAP KPIs (to the extent disclosed in the company's 10-Q or 10-K)
3. A summary of key aspects of company performance
4. A summary of business outlook
5. A brief description of the company's business, sales and marketing
6. Page number references to more detailed information contained in the document (which, if the report is provided electronically, could be hyperlinks).

The Subcommittee's preliminary hypothesis provides that the executive summary should 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. The Subcommittee understands that the inclusion of a summary in the body of the periodic report should not give rise to additional liability implications.

VII. Continued Need for Improvements in the MD&A and Other Public Company Financial Disclosures

The Committee noted in chapter 4 of the Progress Report that while investors and other market participants believe that while there has been some improvement in the MD&A disclosures since publication of the SEC's interpretive release in 2003, significant improvement is still needed. The

Subcommittee evaluated the MD&A and other public company disclosures in the context of its preliminary hypotheses regarding disclosures of key performance indicators, earnings releases, and use of executive summaries in periodic reports.

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