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OFFICIAL OBSERVERS PRESENT

Robert Herz
Charles Holm
Kristen Jaconi
Philip Laskawy
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SEC AND COMMITTEE STAFF

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1 And so one of the notions under bright line that we
2 wanted to tee up for discussion is: Should we go away from
3 an on/off switch and move more toward a proportionality test,
4 where you recognize the proportion of an activity that is
5 influencing the financial results and, in the future, will
6 influence the financial results of the reporting entity?

7 And so you don't have an all-or-nothing test
8 anymore. As you move on a lease, it isn't a 90 percent test.
9 You just reflect that proportion of the economic obligation
10 that is due to the structure of your deal, and you don't have
11 an on/off switch.

12 We think that maybe would help, in the sense that
13 you're not going to have these big surprises because someone
14 hadn't bothered to look at some of the footnote disclosures.
15 Really, disclosures are also very important, but we think
16 recognition needs to be factored in here, too.

17 And so, really, under the bright line, what we were
18 trying to do is say: Should proportionality really dominate,
19 rather than on/off switches, for these bright line tests?

20 We recognize some of these have been there for
21 years as a way to sort of give preparers a safe harbor.
22 Here, if you test this way, you know you're okay. But we
23 think a proportionality test will actually help the preparers
24 in that it helps them understand the range of exposures they
25 truly have.

1 It offers, I think, the single biggest chance for
2 improvement, from a user's perspective, for standard
3 reporting in many years. And it does so because standard
4 setters have really never given much attention to chunking.
5 And this project is doing that. The tentative thinking by
6 the two boards, I think, is absolutely outstanding, and it
7 really goes a long way toward achieving many of the
8 objectives that commenters today and the paper has alluded
9 to.

10 One other point. And that is I thought the
11 discussion on pages 12 and 13 was very substantive. There
12 was one notion, though, I just wanted to mention for caution.
13 And that is the concept of a moratorium. A moratorium is
14 appropriate if there is a light at the end of tunnel when the
15 moratorium comes off. And this moratorium would be a
16 function of the progress on the decision framework on the use
17 of fair values.

18 That decision framework is badly needed, but it is
19 the most controversial thing going in the world of accounting
20 and reporting, in my view. And history tells me that that
21 project could go for a very long time, and a moratorium could
22 turn into a funeral. I think we need to make some progress
23 on fair values in the meantime. So just - I'm a little
24 nervous about moratoriums in this case. Thank you.

25 MR. POZEN: Thank you. Bob?

1 I started addressing the FASB. We then continue
2 that on the top of page 7, saying that it would be good to
3 have a much - in that effort, for the SEC to participate. So
4 instead of, again, codification being a compilation, that the
5 FASB and SEC work together to integrate, where appropriate,
6 the guidance that the SEC and the FASB have given.

7 And, similarly - and I think the point earlier
8 raised this - there is a huge amount of duplication of the
9 companies in their disclosures. So we think there is a huge
10 amount of progress and benefit that can be made from, in a
11 way, using the rear-view mirror to get after whatever
12 guidance is already out there and really change the way that
13 it operates.

14 MR. COOK: Just a question before you get too far
15 away from page 6 on the notion about the agenda committee. It
16 raised a question: Does FASAC not exist anymore? Because
17 this has so many attributes that are common to that.

18 But setting that aside, I just would like a
19 clarification on item 3 about the super-majority. Are we
20 talking about a super-majority of the Board members?

21 MR. SIDWELL: Of the FASB, yes.

22 MR. COOK: Of the Board members.

23 MR. SIDWELL: Yes.

24 MR. COOK: This agenda committee would be an
25 advisory committee --

1 MR. SIDWELL: Yes.

2 MR. COOK: -- and the Board would still have the
3 authority to decide what goes on its agenda.

4 MR. SIDWELL: That's our current thinking. And we
5 did try to contrast what we were talking about here - it's
6 not in the paper, but in one of our meetings - between FASAC
7 and what we're talking about here.

8 And I think we're talking here about something that
9 meets regularly, is very much in the flow of the types of
10 issues that are being seen by the SEC, the types of questions
11 that the FASB staff are getting, and is much more willing to
12 say, "This is an area that we need to prioritize" and get
13 EITF to deal with, get the FASB staff to deal with, or
14 potentially, where the SEC say themselves, you know, "We
15 can't wait for you to do this. We want to do it ourselves."
16 But there is absolutely clarity about what is getting done
17 and who is doing it. And that was really the intent of this
18 agenda advisory committee.

19 In terms of the way standards then get developed,
20 which is the idea on page 8 - you'll be very clear about
21 what the agenda is, you'll be clear about how you set that
22 agenda - one of the ingredients, then, in developing
23 standards from a process perspective that we think is very
24 important is to try and have much more meaningful
25 field-testing cost benefit analysis done throughout the

1 development of the standard.

2 I think that the way we have talked about this, if
3 look at the development of any standard, preparers, users,
4 auditors spend a huge amount of time, anyway, following what
5 the discussion is. Is there a way that we can link that more
6 holistically, so that you have real learning of, "Well, how
7 will this work in practice?"

8 I think it would address some of the questions we
9 have raised about are there difference, even though an
10 activity may be consistent, that you need to consider by
11 different industries.

12 If you then follow our logic, what we are saying,
13 hopefully, you have - because you have developed a standard,
14 you have been much more aware of the issues that are going to
15 be raised by implementations.

16 But we also think - and this really picks up in
17 terms of page 9 - two other aspects that we think that there
18 would be real benefits from always going back two to three
19 years after a standard is issued and say, "What are the
20 issues that have arisen during that period? What are the
21 types of questions the SEC is getting? When Corp. Fin. Looks
22 at specific items, what are the things they're seeing? Has
too
23 much diversity in practice of applying the rules been seen,
24 so that we need to change some of our guidance so that there
25 is more consistency?"

1 Are we missing anyone?"

2 It's really actually - it sounds formal, but I
3 think the goal would be that it's much more timely in just
4 getting everyone on board with the guidance that is given.

5 MR. POZEN: There aren't any more comments on that
6 area, so I think we might move to design of standards on
7 pages 14 and 15.

8 MR. SIDWELL: Yeah. I feel this, at this point, is
9 a little bit motherhood and apple pie, in terms of,
10 obviously, if you move to the point where there is more
11 recognition of professional judgment along the lines that Jim
12 just spent time talking about, we do think, in the design of
13 a standard, there are a number of premises that we think are
14 important that are laid out on page 14, under Hypothesis 21.

15 Obviously, I think there will be a huge interaction
16 with some of the other groups as we develop this, in terms of
17 bright lines, safe harbors, et cetera. So this is really
18 just preliminary thinking, that we do think it would be
19 useful to try and continue to develop the idea of what is an
20 ideal standard, and some of the thoughts that we have are
21 laid out here in detail until we come to the time to develop
22 these.

23 MR. POZEN: Do we have anyone who wants to comment
24 on that? I think we probably pushed that around. And then
25 international considerations is, I guess --

1 MR. SIDWELL: We dealt with that at the beginning.

2 MR. POZEN: Well, I think maybe we ought to just
3 take a short break for 10 minutes or so, and then we will
4 come back and do Subcommittee III. Does that make sense to
5 people?

6 COMMITTEE MEMBERS: (Nodding.)

7 MR. POZEN: Okay. Why don't we do that. Thank you.

8 (A break was taken from 11:40 a.m. until 11:50
9 a.m.)

10 MR. POZEN: We are going to start here and go
11 through Subcommittee III, and then we are going to take a
12 break for lunch. And then we will come back and do
13 Subcommittee IV afterwards, and then leave us a little time
14 at the end to discuss where we go from here. So we are
15 slowly gathering here.

16 We are now at the Audit Process and Compliance,
17 Subcommittee III. And I'd ask Mike Cook, as the subcommittee
18 chair, to lead off.

19 MR. COOK: Thank you, Bob. I was going to just say
20 this is the point at which you thank everybody who has helped
21 you, and that would like take a long time to do that. And I
22 was surrounded by committee members until Greg ducked out,
23 but he's coming back.

24 We have a great committee - Ed and Greg and Linda
25 -- working on this. We have great staff support. Thank you.

1 I would mention Bert Fox, who is very new to the SEC, came to
2 that position - I think he was there one day before he took
3 over our first subcommittee meeting. He has done a great
4 job. So everybody else will have to live with the Academy
5 Award sort of you-know-who-you-are kind of a thank you. But
6 Bert, thank you. Great job. And we do appreciate it.

7 MR. POZEN: I think we should say that each of the
8 people working with the subcommittees has been excellent.
9 Adam Brown and Amy on No. IV and Brett on No. II. And there
10 have been a number of other people - Sharon and Holly.

11 MR. COOK: See, I told you it was - we would be
12 off if we said, "You know who you are," and -

13 MR. POZEN: Okay.

14 MR. COOK: This subcommittee did something that I
15 didn't know what it was until this morning: We chunked our
16 agenda. I didn't even know what chunking was.

17 But we sort of took the scope of our work and
18 divided it into three components, and we have given the
19 highest level of our time and attention to the subject of
20 restatements, with an objective of trying to bring final
21 recommendations to the full committee at our next full
22 committee meeting.

23 And so most of what you will hear about and,
24 hopefully, provide us input about will be the subject of
25 restatements. That is the principal thrust of the paper.

1 MR. POZEN: As usual, Mike has done a brilliant job
2 of summarizing the deliberations on this issue of
3 restatements. But I think there are two very specific issues
4 that I think I would like to get the full committee's view
5 on.

6 One is that the subcommittee debated whether or
7 not, if something was material, maybe it didn't have to be
8 restated, maybe it could have a prospective approach, and
9 decided no, they weren't going to do that. If something was
10 really material, that it should be restated.

11 And then it went on to say that materiality should
12 be viewed as to current investors. And that is a very
13 critical difference, because some things might be material in
14 the past, but no longer in the future.

15 And then third of all, developed this notion that
16 Mike articulated of a sliding scale of qualitative and
17 quantitative.

18 So this is - I mean, there are other issues, but
19 this is a whole framework that the committee has done, and I
20 think we should have some feedback.

21 Denny?

22 MR. BERESFORD: I'm in favor of the general
23 approach that Mike has. I'm not in favor of the interim
24 reporting. First of all, I think it would lead to many more
25 restatements.

1 And I recognize that there is a difference of
2 opinion among accountants - and perhaps users, as well - as
3 to whether the discrete versus integral approach to interim
4 reporting provides the best information.

5 I can make a case for either one. I happen to like
6 the approach in Opinion 28, which is the integral approach.
7 I note that the footnote that was cited in the paper is
8 pretty clear with respect to how you view interim
9 materiality.

10 But I think it would be inappropriate for the Board
11 to take on that as a particular issue without going into the
12 basic premise of interim reporting and perhaps reconsidering
13 coming up with the discrete approach.

14 The problem with the discrete approach is I think
15 that it would take a lot longer for companies to do that on a
16 quarterly basis, and I think it would just be - either that,
17 or they would simply come up with estimates that would be
18 much more problematic on an interim basis and subject
19 themselves to more restatements.

20 So I just think that's one part of the package that
21 warrants reconsideration.

22 MR. POZEN: I happen to agree with you, Denny, on
23 that point, but I think we should have more opinions on that.
24 That's another important issue in terms of reporting.

25 MS. GRIGGS: I don't think we were saying that we

1 disagree with paragraph 28, paragraph, or whatever it is. I
2 think what we were saying was, in the area of interim
3 financials, what we heard some of the investor groups say is
4 that they thought interim financials were very important, and
5 we should not regard them as - just look at the annual
6 period.

7 So I think we are still looking at the impact of
8 errors on interim periods. We were reluctant to - we don't
9 believe that, if errors are discovered in an interim period,
10 you would simply consider those with reference to the annual
11 period and not fix them. We thought errors, generally, that
12 are discovered in a particular period affecting that period
13 should be fixed.

14 But it's historical errors that apply to a prior
15 interim period that we really thought we had to look at the
16 current investors' need for that information. And depending
17 upon when that interim period occurred, it may not be
18 appropriate to restate because it would not be relevant to
19 current investors.

20 MR. POZEN: Well, just to say - a different
21 viewpoint is, to the extent that we want people not to focus
22 that much on quarterly earnings, if we are judging the
23 materiality of an error relative to that particular quarter,
24 rather than the year, you are sort of encouraging people to
25 try to manage those quarterly earnings. And I guess I'm of

1 Yes, Joe?

2 MR. GRUNDFEST: Well, on the different norms, you
3 know, Bob's point, I think, is actually more profound than
4 even he realizes because -

5 MR. HERZ: I don't know if that would be possible.

6 MR. GRUNDFEST: -- because the market has different
7 expectations. All right? And, you know, when you say that,
8 "Gee, you know, 10 percent of companies have restatements,"
9 you mean 10 percent of companies can't get their books right.

10 Well, I think that's as much a negative reflection
11 on whoever it is that made that statement as it is on the
12 restatement process, because, if we come to understand that
13 accounting is, by nature, an imperfect process, even if well
14 done, all right, you expect that, in a reasonable percentage
15 of situations, you will go back after the fact and you'll
16 say, "You know, it would have been better if we would have
17 put this number here and that number there, but we didn't see
18 that at the time."

19 And it doesn't reflect incompetence. It doesn't
20 reflect fraud. It just simply reflects the natural
21 imprecision of the process.

22 So I do think that a piece of what is going on
23 here, I hate to say, is a marketing problem. All right? The
24 idea that, you know, people scream about there being so many
25 restatements, when many of them are technical adjustments.

1 And I can only tell you at this point we have
2 eliminated two possibilities at the extremes. We have
3 eliminated perfection, and we have eliminated anything goes.
4 And everything between perfection and anything goes is still
5 on the table for that.

6 And we have widely disparate views among my
7 colleagues on the subcommittee and me and those who advise
8 us, and it's only because we really have not spent any
9 meaningful amount of time.

10 But when you make a judgment about the application
11 of generally accepted accounting principles, what is the
12 standard against which that judgment should be made?

13 Is it the highest common denominator? Is it
14 preferability? Is it transparency? Is it conformity with
15 the accounting literature? Is it - and, again, there's just
16 a whole array - conformity with economic substance of a
17 particular transaction or event?

18 What is the standard by which that judgment is
19 made? What would someone have to demonstrate that they have
20 achieved to have the benefit of whatever protections would
21 come around that professional judgment?

22 There are other elements in here that we talk
23 about, which we think, again, are - I wouldn't say they are
24 given, but they are generally agreed upon, which is that the
25 judgment process has to be timely.

