

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

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**I. Introduction**

The SEC's Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.<sup>1</sup> 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<sup>2</sup> 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, 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

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<sup>1</sup> Refer to Progress Report at <http://www.sec.gov/rules/other/2008/33-8896.pdf>.

<sup>2</sup> Throughout this report, the term "scope exceptions" refers to scope exceptions other than industry-specific guidance.

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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:<sup>3</sup>

- 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.
- FIN 46R, *Consolidation of Variable Interest Entities*, excludes employee benefit plans, qualifying special-purpose entities,<sup>4</sup> 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

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<sup>3</sup> Refer to appendix A for additional examples.

<sup>4</sup> 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.

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accounting literature. For example, the Derivatives Implementation Group has issued guidance on twenty implementation issues related to the scope exceptions in SFAS No. 133. Further, companies may try to justify aggressive accounting by analogizing to scope exceptions, rather than more generalized principles.

Nonetheless, scope exceptions may alleviate complexity in situations where the costs of a standard outweigh the benefits. For example, many constituents would contend that derivative accounting and disclosures for “normal purchases and normal sales” contracts are not meaningful, and thus, are appropriately excluded from the scope of SFAS No. 133.

**Discussion**

Subcommittee I preliminarily believes that scope exceptions should be minimized to the extent feasible. Possible justifications for retaining scope exceptions 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, and (3) the need for temporary measures to avoid conflicts in GAAP. However, in cases where scope exceptions are provided as a temporary measure, they should be coupled with a long-term plan by the FASB to eliminate the scope exception through the use of sunset provisions.

Subcommittee I also notes that in certain areas, the SEC staff has issued guidance to address transactions that are not within the scope of FASB guidance, e.g., literature addressing the balance sheet classification of redeemable preferred stock not covered by SFAS No. 150.<sup>5</sup> 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.

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<sup>5</sup> *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.*

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## **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 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<sup>6</sup> include different methods of impairment testing for assets such as inventory, goodwill, and deferred tax assets.<sup>7</sup> Other examples include 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.

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<sup>6</sup> Refer to appendix A for additional examples.

<sup>7</sup> 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 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.

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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.

**Discussion**

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

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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.<sup>8</sup>

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,<sup>9</sup> where a mere 1% difference in the results of the quantitative tests leads to very different accounting.

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<sup>8</sup> Refer to appendix B of the Progress Report for additional examples of bright lines.

<sup>9</sup> 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.

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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 *all* 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-

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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<sup>10</sup> 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 *rights to use* 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, a lessee would recognize an asset for its right to use the machine (rather than for a proportion of the asset) at approximately \$35<sup>11</sup> 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

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<sup>10</sup> 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).

<sup>11</sup>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.

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the economics of a transaction legitimately represent an all-or-nothing scenario.<sup>12</sup> 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.

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.<sup>13</sup> 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.

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

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<sup>12</sup> 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.

<sup>13</sup> 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.

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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.

Optimally, the FASB should develop a consistent approach to determine which measurement attribute should apply to different types of business activities. While Subcommittee I is aware the FASB has a long-term project to develop such an approach,

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known as the measurement framework, it advocates three steps in the near term for the Committee's consideration to improve the clarity of financial statements for investors.

First, the Committee should advise caution about expanding the use of fair value in financial reporting until a number of practice issues are better understood and resolved, providing time for the FASB to complete its measurement framework. Second, the Committee should recommend a presentation of distinct measurement attributes on the face of the primary financial statements, grouped by business activities. This will make subtotals of individual line items in the statements more meaningful. Third, the Committee should propose the development of a disclosure framework, which would enable users to better understand the key risks and uncertainties associated with different measurement attributes (refer to section V below).

***Preliminary Hypothesis 4: Avoidable complexity caused by the mixed attribute model should be reduced in three respects:***

- ***Measurement framework – The SEC should recommend that the FASB be judicious in issuing new standards and interpretations that expand the use of fair value in areas where it is not already required,<sup>14</sup> until completion of a measurement framework. The SEC should also recommend that, to the maximum extent feasible, the FASB use a single measurement attribute for each type of business activity presented in the financial statements.<sup>15</sup>***
- ***Financial statement presentation – The SEC should encourage the FASB to:***
  - ***Assign a single measurement attribute within each business activity that is consistent across the financial statements.***
  - ***Aggregate business activities into operating, investing and financing sections.<sup>16</sup>***

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<sup>14</sup> For instance, improvements to certain existing, particularly complex standards, such as SFAS No. 133, *Accounting for Derivatives and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, may be warranted in the near term.

<sup>15</sup> To make this approach operational, the FASB might establish a rebuttable presumption in favor of a single measurement attribute within each business activity (i.e., operating, investing and financing). For example, 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.

<sup>16</sup> Subcommittee I is aware of the FASB and IASB's joint financial statement presentation project and is generally supportive of its direction. Subcommittee I also notes that in addition to the three business activities listed here, the FASB's project contemplates two additional types of business activities—income taxes and discontinued operations.

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- *Add a new primary financial statement to reconcile the statements of income and cash flows by measurement attribute.*<sup>17</sup>
- *Enhanced disclosure – refer to section V of this report.*

**Background**

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,<sup>18</sup> 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

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<sup>17</sup> An example of this presentation is included below.

<sup>18</sup> For instance, additional training for field auditors may be necessary to lessen dependency on valuation experts.

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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.

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

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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.<sup>19</sup>

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

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<sup>19</sup>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.

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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:<sup>20</sup>

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<sup>20</sup> Subcommittee I has adapted and modified this table from a similar schedule in the FASB's financial statement presentation project.

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**Reconciliation of the Statements of Income and Cash Flows**

	A Cash Flow Statement	Non-cash items affecting income				F Income Statement (A+B+C+D+E)	
		B Cash flows Not Affecting Income	C Accruals and Systematic Allocations	D Recurring Valuation Changes	E Other Valuation Changes		
<b>Operating</b>							
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.
<b>Investing</b>							
Capital expenditures	(500,000)	500,000				0	
Sale of available for sale securities	5,000	(4,900)		350		450	Realized gain on sale
<b>Financing</b>							
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 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.

**V. Disclosure Framework**

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.

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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.<sup>21</sup>***

**Background**

Historically, disclosure standards have developed in a piecemeal manner (i.e., standard-by-standard). The lack of an underlying framework has contributed to (1) repetitive disclosures, (2) excessively detailed disclosures that may confuse rather than inform, and (3) disorganized presentations in financial reports. These factors make fulsome and meaningful communication of all material information challenging.

As noted above, disclosure provides important context for the estimates and judgments reflected in the financial statements. However, Subcommittee I acknowledges the perception that amounts recognized in financial statements are generally subject to more refined calculations by preparers and higher degrees of scrutiny by users compared to mere disclosure. As a result, the effectiveness of disclosure standards – whether existing or new – will be governed by the degree to which constituents view them as another compliance exercise rather than an avenue for meaningful dialogue.

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<sup>21</sup> 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.

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Subcommittee I preliminarily believes that a disclosure framework would facilitate this meaningful dialogue between preparers and users. In order for such a disclosure framework to be useful over the long-run, however, it should establish objectives, whose application will vary. Otherwise, disclosure standards will degenerate into myriad rules 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).<sup>22</sup> 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 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

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<sup>22</sup> 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.

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accounting provisions, and (3) an analysis of the key supporting judgments, risks and uncertainties.<sup>23</sup> 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 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,<sup>24</sup> 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,<sup>25</sup> and related sensitivity analyses helpful, as well as an understanding of how "fat" or "thin" the tails of statistical modeling techniques are.<sup>26</sup>

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.

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<sup>23</sup> 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.

<sup>24</sup> 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).

<sup>25</sup> 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.

<sup>26</sup> 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."

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In any event, Subcommittee I acknowledges some disclosure guidance establishes a “floor” for communication between companies and investors, rather than a “ceiling.”<sup>27</sup> 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 of this type.<sup>28</sup> 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.

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<sup>27</sup> 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*.

<sup>28</sup> In particular, the 2001 FASB report on “GAAP-SEC Disclosure Requirements,” which was a part of a larger Business Reporting Research Project.

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## 1. Scope Exceptions

Examples of scope exceptions include:

- SFAS No. 109, *Accounting for Income Taxes*, scopes out recognition of deferred taxes for undistributed earnings of certain subsidiaries and for goodwill for which amortization is not deductible, among others.
- SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* scopes out certain financial guarantee contracts, employee share-based payments, and contingent consideration from a business combination, among others.
- SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, scopes out goodwill, intangible assets not being amortized that are to be held and used, financial instruments, including cost and equity method investments, and deferred tax assets, among others.
- SFAS No. 157, *Fair Value Measurements*, scopes out its definition of fair value for guidance related to employee share-based payments and lease classification and measurement, among others. In addition, they delay in the adoption of SFAS No. 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), effectively scopes out these items for a period of time.
- FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others*, scopes out contracts that have the characteristics of guarantees, but (1) are accounted for as contingent rent under SFAS No. 13 and (2) provide for payments that constitute a vendor rebates (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party, among others.
- FIN 46R, *Consolidation of Variable Interest Entities*, scopes out employee benefit plans, qualifying special-purpose entities, certain entities for which the company is unable to obtain the information necessary to apply FIN 46R, and certain businesses, among others.
- SoP 81-1, *Accounting for Performance of Construction/Production Contracts*, scopes out certain sales of manufactured goods, even if produced to buyers' specifications, and service contracts of consumer-oriented organizations that provide their services to their clients over an extended period, among others.

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## **2. Competing Models**

Examples of competing models include:

- 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.

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