

**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

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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

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- 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

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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

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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 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 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

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.

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).

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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.

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